IMPACT OF HIGH INTEREST RATES ON SMALL BUSINESS CAPITAL FORMATION (PART 2)

HEARING

BEFORE THE

SUBCOMMITTEE ON TAX, ACCESS TO EQUITY CAPITAL AND BUSINESS OPPORTUNITIES

OF THE

COMMITTEE ON SMALL BUSINESS HOUSE OF REPRESENTATIVES

NINETY-SEVENTH CONGRESS

SECOND SESSION

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IMPACT OF HIGH INTEREST RATES ON SMALL BUSINESS CAPITAL FORMATION (PART 2)

WEDNESDAY, FEBRUARY 24, 1982

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON TAX, ACCESS TO EQUITY
CAPITAL AND BUSINESS OPPORTUNITIES,
COMMITTEE ON SMALL BUSINESS,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:40 a.m., in room 2359-A, Rayburn House Office Building, Hon. Henry J. Nowak (chairman of the subcommittee) presiding.

OPENING STATEMENT OF CHAIRMAN NOWAK

Mr. NOWAK. The subcommittee will come to order.

I would like to present an opening statement and give Mr. Marriott an opportunity to speak. Mr. Marriott is under a time constraint because of a markup in another committee, but we do want to have his opening statement in the record. Then we will call our witnesses in the order that they are listed.

I welcome everyone to our hearings on the impact of high interest rates on the small business capital formation process, an issue which the subcommittee addressed in a previous hearing last October.

Today, we will be examining a most distressing phenomenon presently facing our troubled economy, which experts contend may be the most significant impediment to the projected economic recovery. Experts appear extremely concerned and pessimistic over the economic outlook, and confused by the protracted high and volatile interest rates. It seems that economists and analysts cannot agree as to the actual reasons for the prolonged level of high interest rates.

The most frequently mentioned reasons for the persistently high interest rates have been the Federal Reserve Board's tight monetary policy, the demand for credit by the Treasury due to the huge projected Federal deficits, and the inflationary expectations of the financial markets themselves. Although experts cannot pinpoint the exact cause of high interest rates, they do agree that as a result of these interest rates, the country is presently facing a pessimistic economic future which could plunge the Nation into the first depression since the 1930's.

A brief look at some statistical data will serve to demonstrate the magnitude of the effect that high interest rates are having on the Nation's struggling economy. The rate of business failures, first

of all, continues to rise markedly, attributable mainly to the high interest levels. For example, in 1979, failures per 10,000 businesses were 27.8; they rose to 42.1 in 1980; and currently they are running at a seasonally adjusted annual rate of 60.8 in June 1981, according to available Commerce Department statistics. In addition, a recent Federal Reserve Board report indicates that corporate capacity utilization dropped in January as manufacturers operated at 70.4 percent of capacity. As a result, factory output fell a seasonally adjusted 3 percent in January 1982. These statistics clearly indicate that the administration's hopes for an investment-led recovery are not being realized. The rise in business failures and the decline in factory production have obviously had a profound effect on the Nation's severe unemployment problem, recently projected to reach 10 percent.

If we also examine the decline of two of our Nation's vital industries, auto and housing, we are readily able to discern that the interest sensitive sectors of our economy are being decimated by the current high interest rates. According to the most recent Commerce Department statistics, housing starts fell a full 44 percent from December 1980 to December 1981. Further, approximately 2,400 auto dealers have folded since 1980 and additional failures are projected even if sales begin to recover this summer. The drop in auto sales could force 400 of Detroit's auto suppliers out of business, which would result in a permanent loss of some 400,000 jobs by 1985.

As economic conditions deteriorate and interest rates rise, it is no secret that small business is first hit and hardest hit. In view of this fact, the subcommittee intends to spend the next several months exploring various financing proposals designed to ease the present burden of high interest rates on the total small business community.

With that, I would like to call on someone else who has been very anxious about these rates and who has played a role with us in cooperating to try to find some relief in the small business area. Dan Marriott.

OPENING STATEMENT OF HON. DAN MARRIOTT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF UTAH

Mr. MARRIOTT. Thank you, Mr. Chairman.

I will be very brief. I only wish to make a couple of points. First of all, I agree with you that high interest rates are the most serious problem in the country today, especially for small business. No one can borrow money at 21 percent and hope to survive.

I look at the economy as a boxcar sitting on a railroad track with two engines attached to it, one going east and one going west and both pulling at the same time. The one going east is the Reagan fiscal policy, and the one going west is the Federal Reserve. It just seems to me there is no way the two are compatible. The one, supply side economics, is based on the theory of low interest rate, more capital available, and stimulus to the private sector, and, of course, the Federal Reserve's policy is to keep the inflation rate down by tightening up the money supply. With an anticipated $92 billion deficit, that is probably what they should be doing.

So we have a catch-22 situation here at best. The interest rate, as I see it, ought to be about 4 percent above the inflation rate. With the inflation rate today at, say, 9 percent, that means the prime rate ought to be at 13 percent. The reason it is not, as I see it, is that the private institutions are arbitrarily holding it up; that is, there is at least a 4- or 5-percent inflation premium in there because of the lack of confidence in the Government and a lack of confidence because of the deficit levels, and so forth. So somehow we have got to send the right message to the private sector to drop that inflation premium and, then, continue doing the things toward balancing the budget that will ultimately bring the inflation rate down and the interest rates down.

So I say, Mr. Chairman, that we have a tremendous problem. There are no quick fixes for it. We have got to find a solution, or we are going to lose a lot of small businesses. I appreciate your holding this hearing, and I look forward to the testimony.

Mr. NOWAK. Thank you very much, Mr. Marriott.

We think the point about the differentiation between the inflation rate and the prime rate is important. The prime rate was lowered this morning, as I understand it, back to 16½ after 7 days of going up to 17. We have seen it jumping back and forth, and that is another problem that people seem to have, adjusting to those kinds of upgradings and reductions in such a short period of time.

Our first witness is from Chase Econometrics, but before we get to that, I would like to call on another Member who has expressed great concern on behalf of small business with regard to these interest rates, our colleague, Buddy Roemer.

OPENING STATEMENT OF HON. BUDDY ROEMER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF LOUISIANA

Mr. ROEMER. Thank you, Mr. Chairman. I will just take one moment to thank you for holding these hearings, to thank our witnesses for coming, and to respond to a couple of things our colleague, Mr. Marriott, had to say.

I agree with the premise of his remarks a great deal. The effect of high interest rates on all American enterprise is obvious, particularly on small business. But I would say that the nominal interest rates are overstated even more severely than Mr. Marriott would point out to us.

If we take historical real interest rates and add that to real inflation, the prime ought not to be 13 percent, the prime ought not to be 12 percent, or the prime ought not to be 11 percent; in fact, it ought not to be 10 percent. But let us take a conservative 10 percent nominal interest rate compared with the nominal rates as published in our newspapers and in our money market streets. All right, they are at 17. The difference is 7 points, 7 over 10.

We are paying a 70-percent premium for inflation expectation in this country, and it is something small business cannot tolerate. The 70-percent interest premium we are paying now is going to make sure that the President's economic recovery program never materializes.

So wherever we sit in this country politically, wherever we sit in this country philosophically, or wherever we sit in this country eco-

nomically, the truth comes down to two facts. One is that we cannot survive these interest premiums, and, two, the only way to solve them is not to put pressure on the Fed but to put pressure on the U.S. Congress to do its duty in regard to reading the budget and having some fiscal controls in this country.

As a conservative, I am telling you the President's budget is unacceptable in terms not only of its deficit in 1983 or 1984, but the structural long-term deficit that is implied. If you take a 6-percent unemployment rate and look at the budgets over the next 5 or 6 years, there is still a $50 to $60 billion structural deficit. We in Congress have got to come to grips with that, and I hope these hearings help us.

Thank you very much, Mr. Chairman.

Mr. NOWAK. Thank you very much, Mr. Roemer. We will hold the other statements until the witnesses have had an opportunity to come before us.

Our first witness is from Chase Econometrics, Dr. Leon Taub, who is the vice president and chief economist at Chase Econometrics. Dr. Taub, if you would, come forward.

I might mention that Dr. Taub has been with Chase since its inception 11 years ago, and he is a graduate of the Wharton School of Business, and one who has been very active in this debate. I welcome him before the subcommittee.

TESTIMONY OF DR. LEON TAUB, VICE PRESIDENT AND CHIEF ECONOMIST, CHASE ECONOMETRICS

Dr. TAUB. Thank you, Mr. Chairman.

Mr. NOWAK. I might add for your information that if you so desire, all of your written testimony will be put in the record in toto, and you may summarize your statement as you desire.

Dr. TAUB. Thank you, Mr. Chairman. I would like to do that.

Mr. Chairman, and members of the subcommittee, I will present three major points in my testimony today.

First, the cost of money is higher today than at any time in the post-war experience of the United States.

Second, these high interest rates are a direct consequence of policy decisions made by the administration, the Congress, and the Federal Reserve Board. Blaming the Fed for high interest rates, while ignoring the actions of the Congress and the administration, is akin to watching the rope split in a tug of war contest and blaming the result upon one team. This is a similar analogy to one that Mr. Marriott gave a few moments ago.

Third, controlling the economy with high interest rates places a severe burden upon many segments of the economy which are critical to our national well-being. In particular, fixed investment, housing construction, and most small businesses will suffer disproportionately.

At this time, if you would turn to the graphs at the back of my prepared statement, I would like to summarize the information I believe to be contained in the data. The first graph shows two measures of the real interest rate. The utility bond rate, of course, is a measure of interest rates paid by extremely credit-worthy firms. The municipal bond rate is often used as a measure of real

interest rates because it adjusts for the influence of taxes because municipal bonds are tax free. As you can see, by both measures, real interest rates are much higher than they have been at any time in the post-war period.

At this time I estimate this premium—and this is similar to the estimates presented already this morning—is about 4 percentage points above the normal real interest rate.

The second graph shows part of the way we got into this problem. The solid line shows the treasury bill rate. As you can see, it has been high for the last 2 years. Nevertheless, it declined sharply during the 1980 recession and declined sharply again in the 1981 recession, which we are still in. Long-term interest rates, however, did not decline during the second recession; they only declined during the first recession. This is an extremely unusual occurrence, and it is incumbent upon us to ask ourselves why the long-term interest rates did not decline, even though: Short-term interest rates were declining; the inflation rate was declining; and the economy was entering into a recession.

I believe the next few graphs show the answer. On the next page you see the budget impacts of the tax and expenditure proposals of the Reagan administration. In addition, I have provided some indication of the impact of the tax package passed by the Congress last year. As you can see, the impact on the budget margin of the tax cut was extremely large and grows through time.

Mr. Roemer's comment was correct—that it is not just the 1983 budget deficit which is the problem today, but the fact that the budget deficits under current law will become larger in 1984 and 1985.

It is rare that the Congress actually has the opportunity to observe the consequences of its decisions in the financial markets. However, if you turn to the next graph, I think you can see the results of a sort of experiment we carried out last year. That graph shows the yield curve, the difference between short-term interest rates and long-term interest rates at 2 points in time. The solid line was on September 7, before the financial markets knew the size of the 1981 Tax Act. The next was October 2, one month later. As you can see by looking at the far lefthand side of the graph, as we entered the recession, we were entering the recession and short-term interest rates dropped severely, but long-term interest rates rose. This is, of course, the same information presented in that second graph I showed you.

Why did long-term interest rates rise at a time when inflation was falling, the economy was sinking, and short-term interest rates were falling? I believe the only logical explanation is that it was a reaction of the financial markets to the 1981 Tax Act.

I would like now to turn to the consequences of high interest rates upon the economy. An analogy which could be used is that the process that we are talking about now, with a loose fiscal policy and a tight monetary policy, is akin to driving a car by squeezing the gas pedal with one foot and the brake with the other foot. One consequence is that capital formation is severely retarded. Despite the largest corporate tax reduction in history, the cost of capital is as high for equipment and is higher for structures than it was last year; this is shown in figure 6.

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In addition, entire sectors of the American economy have been decimated. Destroying the housing industry will not, in the long run, improve the well-being of Americans or reduce the prices of new homes. Forcing Americans to spend ever larger amounts for home mortgages certainly does not do anything for the economy. Since many small businesses are tied to the housing industry, the destruction of this industry should be of particular concern to this committee.

Another example of an industry which is about to be fundamentally altered as a result of high interest rates is the financial services industry: Banks; savings and loans; and mutual savings banks. During 1982, we are likely to witness a consolidation of the financial services industry on a scale which was unimaginable even a year ago.

Another consequence of high interest rates is that it is extremely destructive to the growth of small business. High interest rates hurt small business in several ways, as you know.

I would like to refer to the data which Chairman Nowak referred to at the beginning of his presentation, the annual failure rate as provided by Dun & Bradstreet. That information is graphed on the last figure in my testimony.

In addition to the June, 1981 data, the last data which is available, I projected the data for the rest of 1981 and for January of 1982 based upon the trends in interest rates and corporate profits. As you can see, if my forecasts are correct—and anecdotal information would suggest they are—the annual failure rate per 10,000 concerns is higher now than it ever has been in our history.

Thank you, Mr. Chairman.

[Dr. Taub's prepared statement with attachments follow:]

PREPARED STATEMENT OF DR. LEON TAUB, VICE PRESIDENT AND CHIEF ECONOMIST, CHASE ECONOMETRICS

It is an honor to be here this morning to present my views on the present high level of interest rates and the forecasts of Chase Econometrics/Interactive Data Corporation. The views and forecasts I present are not necessarily those of the Chase Manhattan Bank, N.A., the parent company of Chase Econometrics.

I will present three major points in my testimony today:

First, the cost of money is higher today than at any time in the post-war experience of the United States.

Second, these high interest rates are a direct consequence of policy decisions made by the administration, the Congress, and the Federal Reserve Board. Blaming the Fed for high interest rates, while ignoring the actions of the Congress and the administration, is akin to watching the rope split in a tug of war contest and blaming the result upon one team.

Third, controlling the economy with high interest rates places a severe burden upon many segments of the economy which are critical to our national well-being. In particular fixed investment, housing construction, and most small businesses will suffer disproportionately.

I. THE PRESENT INTEREST RATE SITUATION

We all know that interest rates are extremely high. However, the full extent to which high interest rates are presently imposing a burden on the American economy is not commonly recognized. In Figure 1, two measures of the real interest rate (the stated interest rate adjusted for inflation) are shown. Real interest rates are important because the difference between the cost of money and the rate of inflation is the burden which businessmen must overcome before undertaking a new project. As real interest rates rise, capital formation is depressed. As is indicated,

recently real interest rates have soared to levels which were thought impossible for the United States economy.

II. THE CAUSES AND CURES FOR HIGH INTEREST RATES

In late 1980, as the United States began to recover from a recession, interest rates began to rise much faster than one would have expected given underlying rates of monetary growth, real growth and inflation. Part of the problem was investor fears that the United States would suffer accelerating inflation due to out-of-control federal non-defense spending and inflationary shocks caused by Middle East oil disruptions. Another proximate cause was the shift in the Fed policy from targeting interest rates to target money supply growth while simultaneously tightening monetary conditions. With less interest rate stability during a time of tightening policy, long-term investors required additional compensation to bear the additional risk.

However, by mid-1981, the situation had changed dramatically. By then it was clear that: (a) non-defense expenditures would be controlled more tightly than had been the case in the past; (b) that inflation was declining at a faster rate than had been expected by most economists; and (c) that economic activity was weak. Furthermore, during the third quarter, even though the economy plugged into its second recession in two years, several sectors of the economy suffered disruptions equivalent to that of a depression, and short-term interest rates began to fall, long-term interest rates rose. This unusual situation is shown in Figure 2.

While part of the problem can be ascribed to an overly tight monetary policy, castigating the Fed for targeting monetary growth at a rate which is 1 percent too low does not make much sense. First, a slightly higher monetary growth rate would probably reduce short-term interest rates by only 1–2 percentage points at most. Long-term rates would fall even less. Even faster monetary growth would probably spark investor fears of renewed inflation and would raise long-term interest rates. Second, we have already borne most of the pain resulting from a too rapid shift in policy. Shifting backward at this point would prove only marginally useful. Third, the freedom of the Federal Reserve has been greatly limited by an overly expansionary fiscal policy, a point I will return to in a moment.

As you recall from Figure 1, real long-term interest rates are approximately 4 percentage points above their "normal" levels. Tight monetary policy and the shift in Fed operating targets can explain, at most, 2 percentage points of that differential. At least 2 percentage points are due to fiscal policy. In Figures 3 and 4, the fiscal policy impacts of the Reagan 1982 budget program are shown. As you recall, the program, as it was actually implemented was even more stimulative than the proposed program. Furthermore, the Congress, by legislating personal income tax indexing in 1985 and thereafter, effectively gave up its control over the revenue side of the budget. This compounded the mistake (from the perspective of financial markets) of indexing most expenditure programs.

It is rare that the Congress can actually see the financial market's consequences of its policies. However, last summer the effect of the Congress' decision to expand the Reagan tax cut program was dramatically illustrated. Figure 5 shows the yield curve on August 7, before the revenue loss impact of the 1981 Tax Act were widely recognized. The same yield curve is shown one month later. Despite the fact that the economy and short-term interest rates were collapsing, long-term interest rates actually rose by almost one percentage point. That increase is a minimum estimate of the increased risk which investors perceived as a result of the tax act. A further increase in the risk premium undoubtedly occurred before August 7 as it became increasingly clear that the Congress was going to pass a budget-busting tax package.

Earlier I noted that interest rates would be reduced, and the growth rate of the economy accelerated, if we had an easier monetary policy. However, as you know, the members of the open market committee are facing current law deficits of at least $110 billion this year, $150 billion next year, and $200 billion in 1984. Under these circumstances the risks of following an easier monetary policy are excessive. While the consequences of mixing a tight monetary policy and a tight fiscal policy are uncertain, the combination of a loose fiscal policy and a loose monetary policy is a known prescription for disaster. It certainly seems silly to drive a car by squeezing the gas pedal with one foot and the brake with the other foot. However, pushing the accelerator to the floor while severing the brake connection would certainly prove fatal.

III. THE CONSEQUENCES OF HIGH INTEREST RATES

Although possible in theory, the consequences of controlling the economy through a combination of a tight monetary policy and a loose fiscal policy are quite serious.

First, capital formation is severely retarded. Despite the largest corporation tax reduction in history, the cost of capital is as high for equipment, and is higher for structures than it was last year. This situation is shown in Figures 6. Second, entire sectors of our economy have been decimated. Destroying the housing industry will not, in the long run, improve the well-being of Americans or reduce the prices of new homes. Forcing Americans to spend ever larger amounts of money on home mortgages certainly does not do anything for the economy. Since many small businesses are tied to the housing industry, the destruction of this industry should be of particular concern to this committee. Another example of an industry which is about to be fundamentally altered as a result of high interest rates is the financial services industry. During 1982 we are likely to witness a consolidation in the financial services industry on a scale which was unimaginable even a year ago.

Another consequence of high interest rates is that it is extremely destructive to the growth of small businesses. High interest rates hurt small businesses in several ways. As I have already noted, small businesses are often found in those industries which are sensitive to high interest rates. Also, when interest rates are high, the least credit-worthy borrowers are squeezed out of the market. Small businesses, with their small asset bases and short credit histories, are squeezed particularly severely. One further perversity is that those small businesses which are growing the most rapidly, and consequently are facing the largest increases in receivables and capital needs, are hurt as much or more than the more stable businesses.

Since high interest rates depress equity values, it becomes almost impossible for new businesses, even new businesses with tremendously improved products and/or production methods to raise capital. Thus technological progress is impeded. Finally, high interest rates create a period of economic adversity in which the odds are stacked heavily in favor of large firms which can withstand even several years of an unfavorable economic environment. Last year, business bankruptcies were at their worst level since the Great Depression. This occurred despite a relatively favorable first half of the year. As is shown in Figure 7, we estimate that the second half of the year saw business bankruptcies at well over 70 per 10,000 concerns. Furthermore, this year, as continued weak sales and high interest rates combined with an atrophied financial base, we believe the number of bankruptcies is both greater than at any time in the past and increasing.

Thank you.

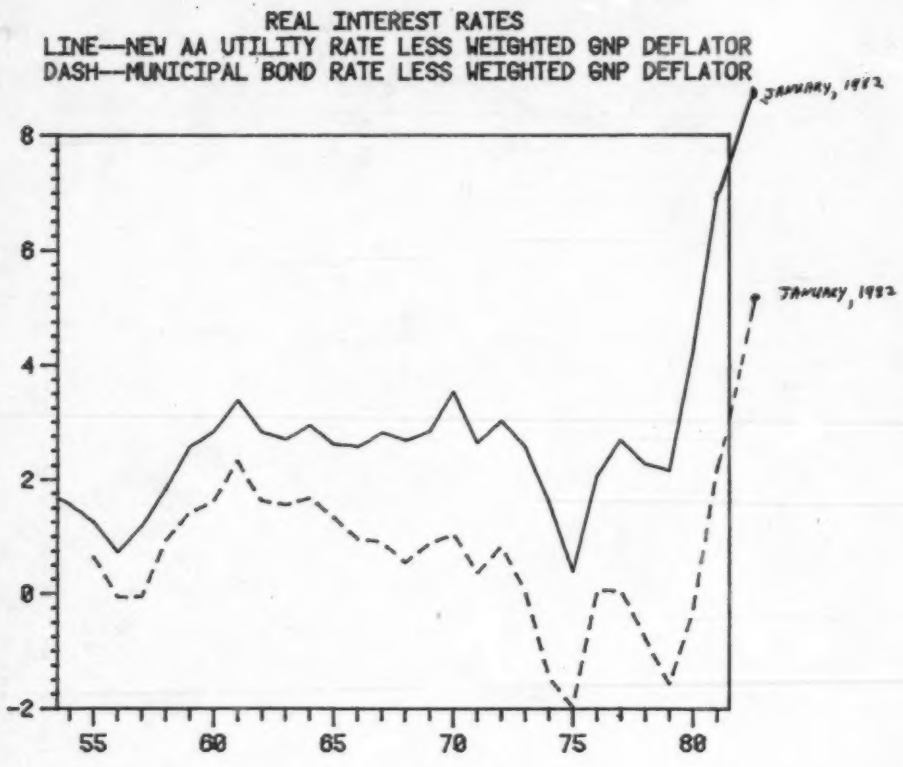

REAL INTEREST RATES
LINE---NEW AA UTILITY RATE LESS WEIGHTED GNP DEFLATOR
DASH---MUNICIPAL BOND RATE LESS WEIGHTED GNP DEFLATOR
JANUARY, 1982
JANUARY, 1982
8
6
4
2
0
-2
55
60
65
70
75
80

Figure 1

INTEREST RATES
LINE--3 MONTH TREASURY BILLS
DASH--NEW AA UTILITIES RATE

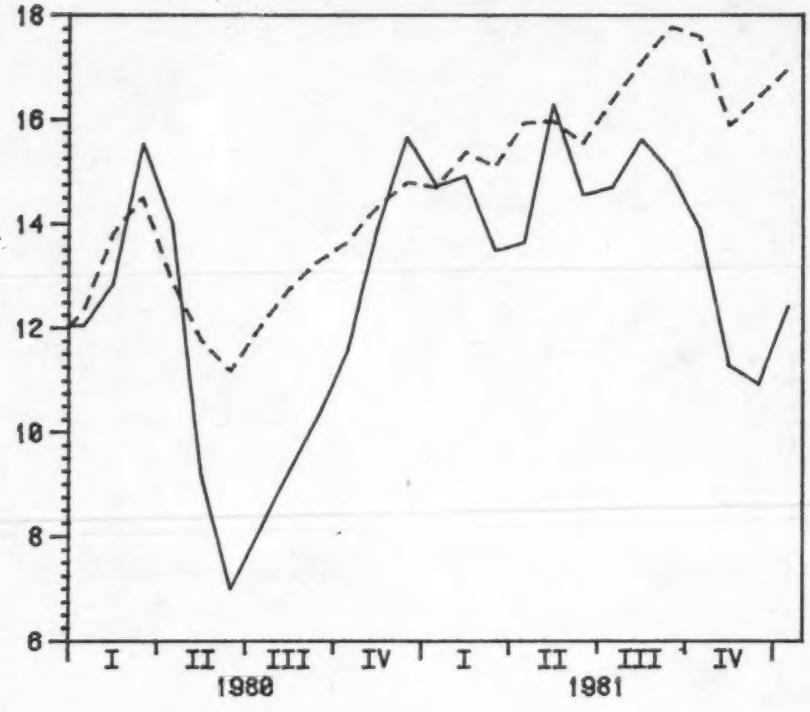
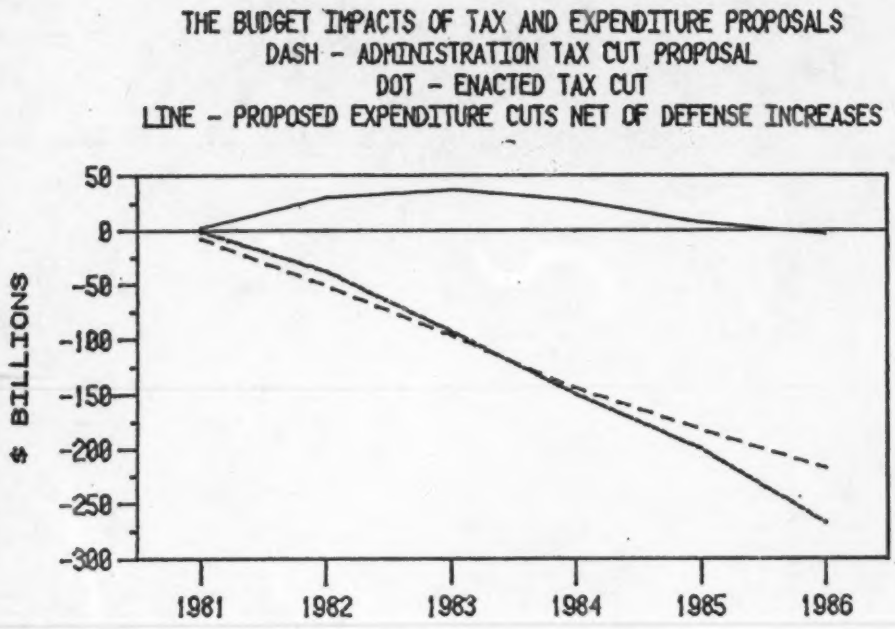
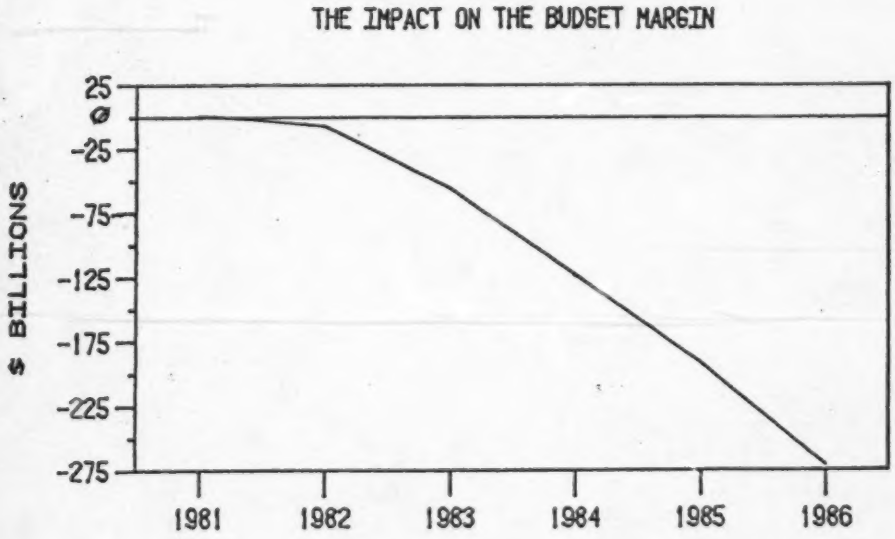


Figure 2





Figures 3 and 4

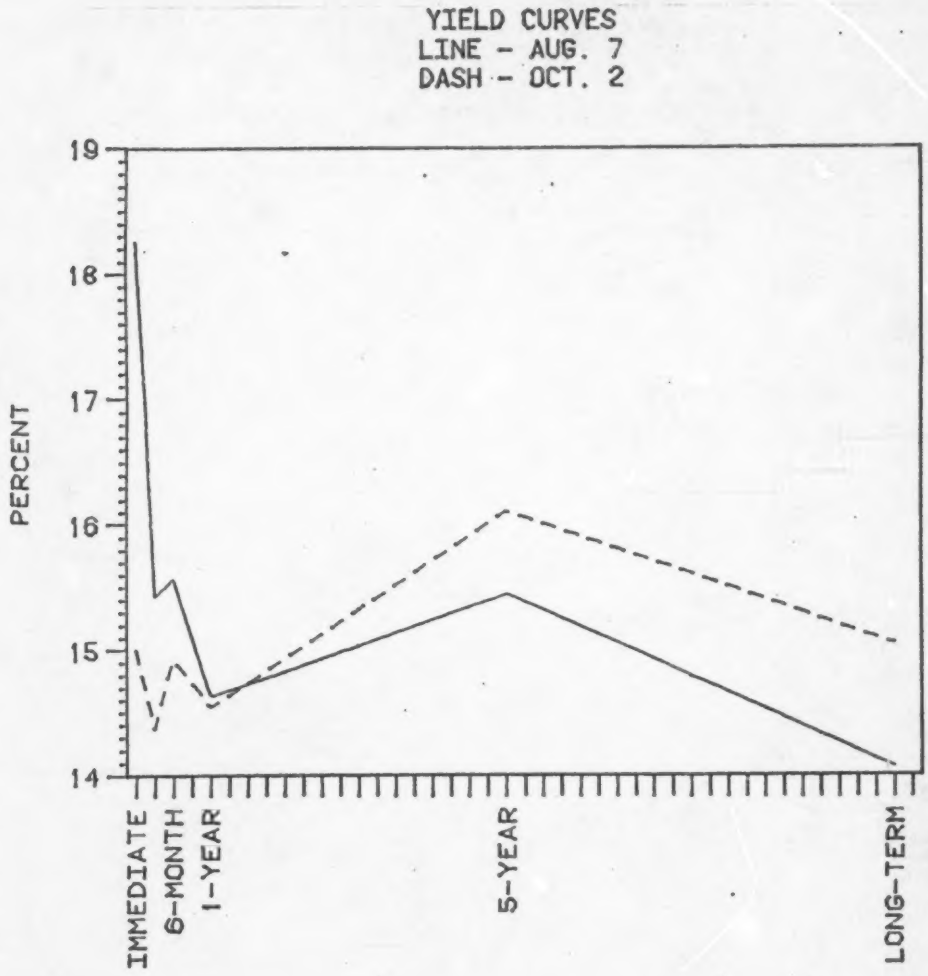

YIELD CURVES
LINE - AUG. 7
DASH - OCT. 2
PERCENT
19
18
17
16
15
14
IMMEDIATE
6-MONTH
1-YEAR
5-YEAR
LONG-TERM

Figure 5

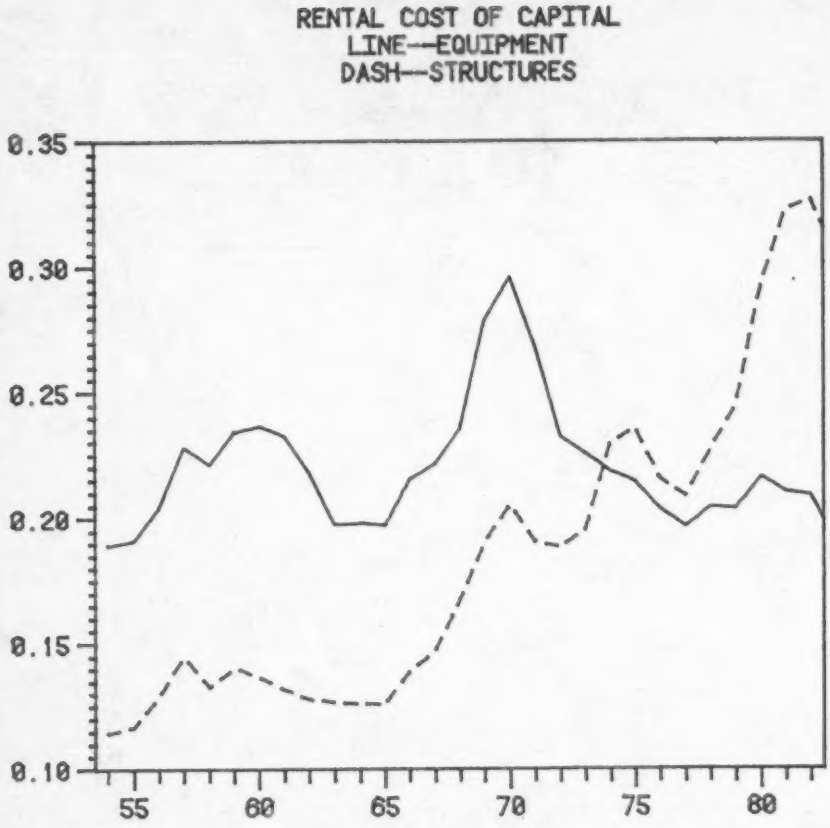

RENTAL COST OF CAPITAL
LINE--EQUIPMENT
DASH--STRUCTURES
0.35
0.30
0.25
0.20
0.15
0.10
55
60
65
70
75
80

Figure 6

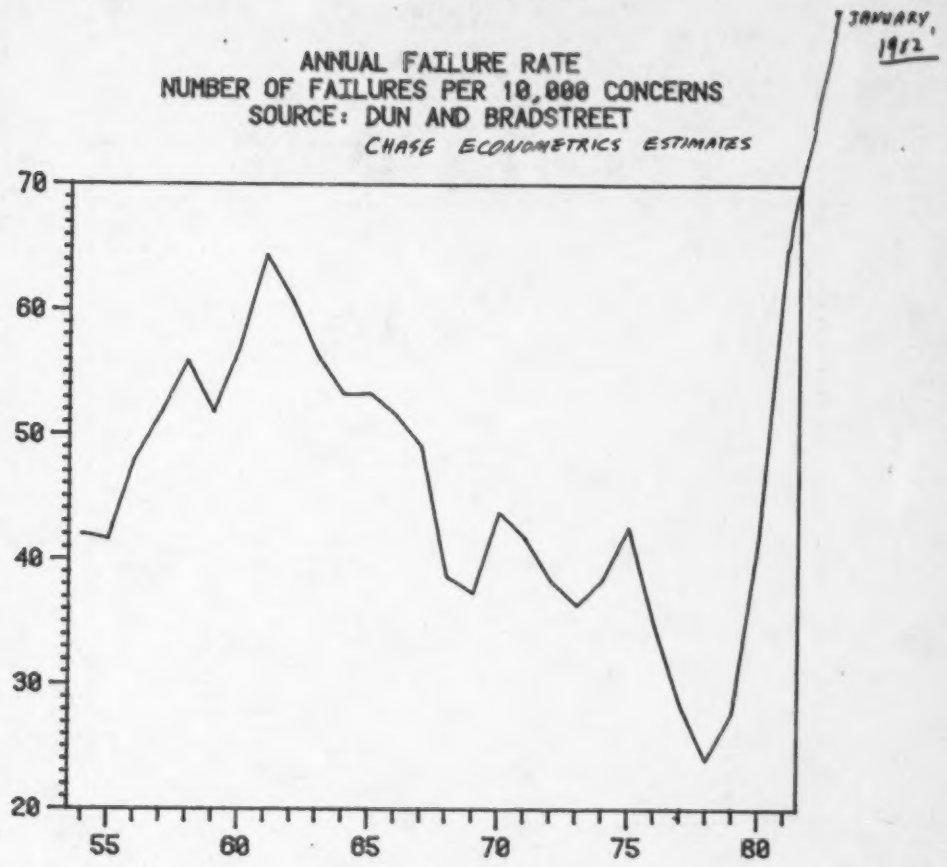

ANNUAL FAILURE RATE
NUMBER OF FAILURES PER 10,000 CONCERNS
SOURCE: DUN AND BRADSTREET
CHASE ECONOMETRICS ESTIMATES
JANUARY 1982
70
60
50
40
30
20
55
60
65
70
75
80

Figure 7

Mr. NOWAK. Thank you very much, Dr. Taub. I think that your explanation, especially of the graphs, does verify the written part of your testimony. They are very complete.

Let me ask you a couple of questions briefly. I know the other members here have other commitments, so I will be very brief initially.

Do you see any relief from the level of the interest rates if the administration's plan as it is now constituted remains the same and goes through the House and Senate and is approved?

Dr. TAUB. Under those circumstances, I would expect interest rates to be higher this fall than they are right now. There might be a slight drop in between, because of the seriousness of the recession and the fact that the financial markets are anticipating the bad news of 1983 and 1984 perhaps a bit too fearfully, but I do not see any sustained downturn in real interest rates as long as we are facing a Federal budget which is basically out of control.

Mr. NOWAK. What kind of recovery do you expect, if any, if generally this administration's plan as it is constituted now goes through?

Dr. TAUB. I expect an unbalanced recovery. I am not among those, and Chase Econometrics is not among the firms, which believe that: (a) The economy will continue spiraling down to depression; or (b) we will begin to have a very slow anemic growth. The fiscal stimulus provided by the tax cut is extremely great, and I expect the consumer to respond very favorably by the summer of this year.

The problem is that not all sectors of the economy will benefit. In particular, those sectors of the economy which are dependent upon high interest rates will remain in the doldrums while the rest of the economy grows rapidly. In addition to that, controlling the economy through a combination of loose fiscal policy and tight monetary policy tends to produce a stop-and-go type of economic environment. We will have a few quarters of very rapid growth, and then interest rates will rise high enough to choke off economic activity, and we will move down sharply for a quarter or two. This happened in 1980, and again in 1981.

Mr. NOWAK. Let's try to get a little more specific. Let us talk about the housing industry or the auto industry, which I believe are very closely related, in some aspects, anyway.

What about the impact upon those industries which really have so much of a spinoff effect or broader impact on small business in our economy? If the structure stays the same and as Mr. Marriott and Mr. Roemer said, with the inflation expectation, there has been great concern that as the economy starts to live within that structure, the standard or the quality of life in the country is going to be diminished to the point where you are not going to have any upgrading or mobility upwards either in housing or in transportation.

What would you foresee for the housing industry? Let us take that as a particular item. What effect do you think this will have upon the whole notion of the American dream to own a home, to get your first piece of investment in the country, and to enter what I consider to be the free enterprise system when you buy a home and start acquiring some equity? What do you think will happen to

that whole premise because of the structure if we continue it for several years?

Dr. TAUB. Typically, during a recovery housing starts rise 50 percent to 100 percent. If circumstances do not change, I would expect the recovery in housing to be much more anemic, perhaps 20 percent. This is a direct consequence of houses being unaffordable, not because the prices of houses are rising rapidly, but simply because home mortgage rates are so high and the interest costs are so severe. If that progresses for a few years, we will, of course, develop a shortage of new homes, of such magnitude that then when interest rates do fall, housing costs will skyrocket. It would put new home buyers in a Catch 22 position, where even if rates fell, they wouldn't be able to afford new homes; but in the present circumstances most homes are unaffordable by most young Americans.

Mr. NOWAK. Wouldn't it also tend to put us perhaps in a position similar to some of the European countries or I should say, most of the European countries, where owning a home is something you postpone until you save for a lifetime, and so you rent?

Will we change the whole structure so that people become renters now instead of homeowners? Do you see that as another consequence of these rates?

Dr. TAUB. That would be one response. Also, we have seen some persons delaying childbearing in order to be able to buy a home, fearing they won't be able to buy one. You have a variety of responses, and both of those——

Mr. NOWAK. You might even increase the abortion rate if you carry it out far enough, I suppose.

Dr. TAUB. Well, there is no question that affording a home is one of the few financial worries faced by even those young Americans with secure jobs; and, of course, the percentage of them has declined in the past year as well.

Mr. NOWAK. Thank you very much.

Mr. Marriott?

Mr. MARRIOTT. Thank you very much, Mr. Chairman.

I guess if you can believe any economist these days, you can believe Chase Econometrics. I appreciate your testimony.

Dr. TAUB. Thank you very much.

Mr. MARRIOTT. Let me ask you this question: How much has the inflation rate reduction now affected the interest rates?

In other words, when Carter left office, the inflation rate was 14 percent; the prime rate was 21½ percent. Now it is 8 and 16½ percent, let us say.

Let me make one other point first. The budget deficit in 1976 was 4 percent of gross national product. Today the new budget deficit is 2.7 percent of the gross national product. Does that make a difference? I mean, is the size of the deficit having that much of an effect on the interest rates? The interest rates were lower in 1976, and yet the deficit was a higher percent of the GNP. So how do you relate those two factors?

Dr. TAUB. There are two questions. The first is the effect of inflation on interest rates. There is no doubt we have made substantial progress against inflation during the past 2 years. Part of it has been due simply to lower oil prices, but a lot of it has been due to conscious Government policy, including a tight monetary policy.

Nevertheless, the decline in interest rates has not been as great as the decline in inflation. That is what we mean by saying the real interest rate has risen.

Mr. MARRIOTT. Is that the case because people are still uncertain? Do you put the uncertainty factor in there as the reason for that?

You indicated that probably the prime rate ought to be 12 percent today; it is still 16½ percent this morning. That is 4½ percent higher than you recommend. Is that still an uncertainty premium?

Dr. TAUB. Yes. I agree with you that it is not today's deficit which poses the problem to the financial markets. In fact, it is appropriate, given the seriousness of the current economic downturn. I think the problem is uncertainty and risk concerning the budget in 1983 and 1984, and indexing in 1985 and beyond.

Mr. MARRIOTT. All right. I want to come back to that.

Are you saying you don't think the level of the deficit, the $92 billion that we are all going to be arguing about the rest of these next 2 months, is the problem?

Dr. TAUB. The 1982 deficit, according to our estimates, will probably—on a national income account basis—be between $115 and $120 billion. That is not the problem. The problem is that under current law the deficit will be worse in 1983, $150 to $160 billion by the Congressional Budget Office's estimates, and $200 billion by 1984, by Congressional Budget Office's estimates. The problem is those deficits occurring, despite an assumption of fairly rapid growth. Both of those cast an onerous shadow that has the financial markets so frightened.

Mr. MARRIOTT. How much of that deficit is the result of the fast decrease in the inflation rate? In other words, we have gone the last year from, let's say, 14 percent to 8 percent, which is a 6-percent drop. What effect is that drop in the inflation rate having on the present budget estimates, and the deficit estimates?

Dr. TAUB. Let's see. Six percent higher inflation would reduce the budget deficit by, well, of course, you are talking about going through several years because in the first year you get the maximum reduction, and then indexed expenditures rise. Without going through all of the calculations, I would guess the deficit in 1984, under current law, rather than being $200 billion would instead be closer to $125 billion.

Mr. DORGAN. Will the gentleman yield on that point?

Mr. MARRIOTT. Sure.

Mr. DORGAN. The figures 14 percent and 8 percent, which would be a 6 percent improvement in the consumer price index, are those real figures or hypotheticals?

If we are using annualized improvement figures in the cost of living, have we made 6 percentage points real progress at this point?

Dr. TAUB. I had assumed those were hypothetical figures. The annual inflation rate was not 14 percent in the recent past.

Mr. DORGAN. OK. That was my point, because I don't think that we have made that kind of improvement.

If the other side would just yield for one more minute, I think you have answered that you will have substantial increases in entitlement costs as inflation rates increase, and, therefore, an in-

creased likelihood of higher budget deficits. But I just want to make that point about improvement. We certainly have made some improvement on the inflation front, there is no question about that.

Dr. TAUB. That's right. Also, if we had a Fed policy which accommodated that kind of inflation, we would probably have nominal interest rates of 20 percent now. It would be higher, rather than lower, because investors right now, I think, are frightened because we are driving the economy with one foot on the gas and one foot on the brake. I think if both feet were on the gas, there would be even more concern.

Mr. MARRIOTT. In terms of deferring the tax cut, what would that do to the interest rates?

Dr. TAUB. I would like to make a distinction between deferring the second round of the tax cut and deferring the third round of the tax cut.

I don't think deferring the second round of the tax cut would be productive because of the severity of the current recession.

If we both deferred the third round of the tax cut and made indexing contingent upon some sort of economic performance, or, on the other hand, gained some control on the expenditure side, which is indexed, so that the Congress had at least control of one side of the budget or the other, I think that would substantially reduce real interest rates and improve economic performance, perhaps as much as 2 percentage points.

Mr. MARRIOTT. If Chase Econometrics was now called upon to advise the Congress as to exactly what we should do with this budget to get interest rates down and do all of these other things to turn the country around, what would your recommendation be? One of the Members said that the budget was totally unacceptable. What alternatives are there to that? What would you do? What are the steps you would take with both the monetary policy and the fiscal policy now, to make sure that we got this country going again? What would your solution be?

Dr. TAUB. The program we proposed last fall was to advance the second stage of the personal income tax cut to essentially right now——

Mr. MARRIOTT. Step it up, you mean?

Dr. TAUB. Step it up. Delay the third phase, or make it contingent upon the level of economic performance. Also, I think some of the corporate tax reductions were greater than are reasonable and changes should be made there. We are overcompensating for depreciation now.

On the expenditure side, we must——

Mr. NOWAK. Excuse me just a minute.

You had talked about the delay of the third so-called 10 percent.

Dr. TAUB. Right.

Mr. NOWAK. And the second 10 percent. What about the indexing, which I think is a very important part of all of this, especially as we look at the longer kind of borrowings and the anticipations that are out there by people who have control over the borrowing? You didn't mention that in your resumé, and you went to the expenditure side; I wonder if you could comment on that point.

Dr. TAUB. Thank you. I was going to discuss indexing on both the expenditure side and the revenue side together.

I think the single most important step we can do is eliminate the indexing of personal taxes in 1985 and thereafter. By the same token, I think we must do something about the indexing of expenditures, particularly the social security indexing. As I am sure all of you know, by this time next year the Social Security trust fund will be out of money.

There are several ways to deal with that; it seems to me one of the most politically palatable and equitable ways would be to reduce social security indexing.

Even aside from that argument, it is clear that social security is rapidly becoming a third of the national budget. I guess it is close to 30 percent of the national budget now. We certainly can't talk about controlling budget expenditures while that segment of the budget is completely out of the control of the Congress and, in fact, is growing faster than wage rates or prices, by most standards.

I think that an arrangement, perhaps tacit, but an arrangement should be made with the Federal Reserve Board that if the Congress took these extremely strong steps to control the budget deficit, that in return, less monetary tightness would be necessary, and that the money supply target should be raised by at least a percentage point.

So that the comprehensive program would have to hit on the expenditure side.

Other expenditure cutbacks would have to be made, as well, including some of the nondefense expenditure cutbacks outlined by the President. Probably some of the defense expenditures, as well. Then, of course, the easier monetary policy would be another component.

Mr. MARRIOTT. One last question. Do you have any confidence in supply side economics? You talk about stepping up the second tax cut. Can that kind of spending or tax cut so stimulate the economy that we can double the revenue side of the equation and do all of the wonderful things that were done in Kennedy's administration?

How does Chase Econometrics look at the role that supply side economics has now to increase the revenue side?

Dr. TAUB. There are 2 points about supply side economics that I would like to make. The first is that no one has ever questioned the direction of the impact, but there was a question of the magnitudes. I think even most supply side advocates would now concede that they didn't expect revenues to actually increase as a result of the tax cuts.

Certainly the cut in the top bracket from 70 percent to 50 percent will raise revenues.

The vast majority of the tax cuts, though, will lose revenues, in varying degrees. The second point that I would like to make is that there are many aspects of the policies which we are following today which are, in my mind, the antithesis of supply side economics.

For example, we are cutting transfer payments to the working poor, but not cutting transfer payments to those who are even poorer. That imposes an effective marginal tax rate upon these people which is much higher than any working person faces.

Because we are following a program which is unbalanced, in terms of fiscal policy and monetary policy, we are actually raising the cost of capital.

Finally, on the corporate side, we have a very, very high marginal tax rate, 48 percent, and yet the average tax rate is only about 20 percent. Essentially, we are forcing businesses to spend most of their time engaging in tax avoidance. That is the antithesis of what we should be doing, as I see it.

Mr. MARRIOTT. Thank you.

Mr. NOWAK. Thank you very much.

We have about 1 hour, about 40 minutes, and I have to leave for some period of time for lunch. But we want to give both of our other members here the opportunity to take as much time as they can, because I think this is a very important witness.

We will now hear from Mr. Dorgan from North Dakota. I would like the witness to stay. I am going to leave, but I don't want you to leave.

Mr. Dorgan is another member who has participated in this debate all the way down the line in trying to find the solution that makes some sense, and I think the detail that he has presented to myself and to the other Members of the House has been very good and substantial input.

I now recognize Mr. Dorgan.

Mr. DORGAN. Thank you, Mr. Chairman.

Could you tell me, Dr. Taub, what the anticipated fiscal year 1982 Federal deficit is? You alluded to it earlier, and I missed the number.

Dr. TAUB. On a national income account basis, my latest estimate is about $115 billion to $120 billion.

Mr. DORGAN. That is for fiscal year 1982?

Dr. TAUB. That is for calendar year 1982.

Mr. DORGAN. Calendar year 1982.

Dr. TAUB. The fiscal year deficit will probably be $5 to $10 billion less.

Mr. DORGAN. So you are saying that it is possible that the fiscal year 1982 deficit is going to be $105 to $110 billion, based on your latest analysis?

Dr. TAUB. Yes.

Mr. DORGAN. Now, I have got to say—and I don't mean this to be partisan—Jimmy Carter created a tremendous economic mess in this town, in my opinion, and I think Ronald Reagan is digging a deeper trench in a shorter time. We are careening down the economic road. It is just staggering, to me, to see what is happening to the economy. All of us act like we are going to be bumpers here to try to keep things just on a broad economic path that doesn't seem to be in our best interest.

You touched on interest rates. I would like to focus on those in a moment. First, let me say that the President's proposed tax program was just fundamentally wrong: You can't just decimate your revenue side and not expect to come up with incredible deficits. I didn't find many economists last year who believed it. Now almost every economist is protesting that they spent all of last year disbelieving it. They weren't quite as loud last year! But aside from that tax cut problem, which is a very serious problem, and the budget

problems, the interest rate problem is a problem of great concern to the small business community.

You are saying that the blame should not be laid completely at the feet of the Federal Reserve Board.

Before the monetarists took over in this country, which was a couple of years ago, we didn't have the kind of fluctuation in interest rates, that we have today. The fact is, we had some pretty significant budget deficits. I think the highest deficit in the history of this country was under the last year of President Ford, which was about $65 billion, and that wasn't accompanied by 17-percent interest rates. What causes interest rates to be at 17 percent today, in your opinion?

Dr. TAUB. In addition to the facts that I have discussed in my verbal comments, and in my written testimony, I would like to mention another fact which is one you are alluding to.

Prior to the fall of 1980, the Federal Reserve Board targeted interest rates. Since then it started targeting money supply. Now, you have your choice. You can control one closely or you can control the other closely. The Fed, by targeting on money supply, meant that it felt that it would be OK to allow interest rates to fluctuate more rapidly or with a greater amplitude. The combination of that happening, on top of a simultaneous tightening of money supply, I believe also disrupted the financial markets and was one component of the high interest rates that we see today.

Mr. DORGAN. I understand the connection between the money supply and inflation, and I am not diminishing its importance. But I am saying that the Federal Reserve Board artificially manipulates the money supply based on their own targeting projections. Right?

Dr. TAUB. It certainly tries to.

Mr. DORGAN. All right; they try to.

If, in the supply-demand curve for money you are controlling one side, aren't you in effect administering interest rates and, therefore, isn't the cause of today's high interest rates laid right at the feet of the Federal Reserve Board?

Dr. TAUB. The cause of the violent fluctuations in interest rates——

Mr. DORGAN. I am not talking about the fluctuation; I am talking about the 17 percent.

Why is it at 17 percent? Isn't it because that on the supply-demand curve relationship, one of those curves, the supply curve, is controlled by the Federal Reserve Board that, in effect, administers the price at 17 percent, not precisely, but at that level?

Dr. TAUB. It is controlling the supply; demand can fluctuate. If the Fed allows a larger supply, it might be that the entire demand curve would shift upward and, in fact, that is exactly what I think would happen. If the Fed said, "OK, let's pump money into the economy," given the same fiscal policy we have, people would look at that and say, "Oh, my, we are going to go to hyperinflation," and interest rates would stay as high as they are now. So the Fed doesn't have the freedom that it might have at other times, as I see it.

Mr. ROEMER. Will the gentleman yield to me?

Mr. DORGAN. I will be glad to yield.

Mr. ROEMER. As evidence that your answer, in my mind, is truthful and matches with economic reality, look at the last 2 months. In January, late December, the money supply increased sharply. Nobody is sure why, but it did.

What was the response of the marketplace? Interest rates went up, not down. We are in one of those anomalies of economic history where at this point in time tight money might mean lower interest rates than loose money, in terms of monetary policy, because the one given that the street, that your corporations, that your businesses, that your individuals are trying to be productive, and mine, find unfathomable, unpredictable, is what we are going to do with fiscal policy.

Would you agree with the statement—if, having interrupted, I can proceed—that it is fiscal policy at this point that is in our hands and that remains the culprit out there in America and not monetary policy?

Am I wrong by saying that, or am I right?

Dr. TAUB. I think fiscal policy is the most important factor, but I would not exclude monetary policy entirely. There may be a middle ground.

Mr. DORGAN. Will the gentleman yield?

Mr. ROEMER. Sure.

Mr. DORGAN. I disagree. This isn't the province for our debate to occur, but I think that high interest rates are administered largely by the Federal Reserve Board. As long as they control that supply side of the supply-demand curves, they are targeting where they want the cost of money to be, in order to dampen demand. All right. If that is true, and if at the same time we have an administration that says we want fiscal policy that relies on explosive amounts of economic growth to work, but we also support monetary policy that is designed to retard growth. Isn't that an economic schizophrenia that you can't recover from?

Mr. ROEMER. That's a leading question.

Dr. TAUB. It is a conflict which tends to lead to unbalanced growth and very high interest rates.

Mr. DORGAN. But note, isn't it a conflict that leads not to unbalanced growth? Isn't it a conflict that leads to no growth? Isn't it a conflict that leads, inexorably, to this recession?

Dr. TAUB. It leads to slower growth than we would have with a more balanced policy. I wouldn't say no growth. It certainly reduces capital formation, reduces the potential growth rate of the economy. I think some sectors of the economy will experience very rapid growth in the next few months.

Mr. DORGAN. But we are now involved in a recession, we are involved not in growth, we are involved in no growth or negative growth. That is brought about by the conflict in fiscal policy and monetary policy. More specifically, my guess is that it is brought about by high interest rates, from the presence of the monetarists' theory of controlling the money supply. Do you agree with that?

Dr. TAUB. I agree it is brought about by high interest rates. I am a little hesitant to embrace that line of reasoning fully as it might be an excuse to blame the Fed for the present situation.

Mr. DORGAN. I don't like to blame the Fed, just for the heck of it. I don't like the Fed, as a matter of fact. I don't think what they

have done has been of great service to this country. If it were fun, I would blame them just for fun. But I don't think it is productive to say that the Fed is at fault if in fact it was fiscal policy that was at fault.

I think this Government has been embarking on fiscal policy strategies that give us the look of inebriation over the years. But that doesn't deny the fact the monetarists who took control of the Fed, have tightened the money supply, increased interest rates, and thrown this country into a recession.

You are not going to have economic growth with 17 percent or 20 percent interest rates, it is not Carter's interest rates, or Reagan's interest rates. It is Paul Volcker's interest rates.

Dr. TAUB. I don't think so. I think that argument was strong in late 1979, 1980 and 1981; but right now I think Mr. Volcker's actions are constrained by the budget situation. He doesn't have many choices.

Mr. DORGAN. I am not suggesting he is reckless. Mr. Volcker is right on plan. He is doing exactly what he wants to do.

I will conclude with this line of questioning, Mr. Chairman. Are you suggesting that the tight money is not what is responsible for high interest rates?

Dr. TAUB. I think interest rates today would be almost as high under virtually any type of monetary policy.

Mr. DORGAN. Why?

Dr. TAUB. Because if the money supply were loosened and we had both a loose monetary policy and a loose fiscal policy, inflation would be out of control. We wouldn't have made the progress against inflation we made.

Mr. DORGAN. Why in 1978 or 1977, for example, was the relationship of interest rates and inflation so much different than it is today, if you are suggesting that the cost of money represents the anticipation of the individual who is loaning that money of what future inflation will be?

Dr. TAUB. I think the largest single factor is that people perceive the budget to be out of control, where people did not perceive the budget to be out of control at that time.

Although deficits were large, there was at least the projection that inflation would eventually bring in revenues. A second factor would be tight monetary policy.

Mr. DORGAN. Your statement is very good. You answered very carefully, and I appreciate it. I used to teach a little economics. You know, this is not a science, I understand that. I am sure you know that.

Mr. Chairman, thanks for indulging me in that line of questioning.

Mr. NOWAK. You are welcome.

You know, somebody has suggested the difference in the relationship between inflation and interest now and what had previously been in the structure in the 1940's, 1950's, 1960's, 1970's, and that the imbalance now is caused by what we, I guess, have referred to here as inflationary expectations or anticipated problems in the future. Someone else recently told me, "No, that has nothing to do with it. It is just plain greed."

I wonder if you could comment on that, on the fact that people will seek to invest their money where they can get the highest possible return with the least possible risk? Isn't that a factor?

Mr. MARRIOTT. It is called the profit motive.

Dr. TAUB. I wouldn't ascribe that to greed. That would be——

Mr. NOWAK. Smart investing?

Dr. TAUB. That people try to get the most for their money, that people try to buy as many goods and services as they can with their income is what we take as the basis for our capitalistic economic system.

Mr. NOWAK. It still doesn't explain the difference, though, in the relationship between inflation and interest.

But let's skip over it, because I want to recognize Olympia Snowe, the gentlewoman from Maine, who has sat here patiently and who has been involved in the other hearings also.

Mrs. SNOWE. Thank you, Mr. Chairman.

Thank you, Dr. Taub, for appearing before this subcommittee on a very important issue.

You mentioned that budgets have been out of control; that's a concern of this country, the business community, and the financial community.

The fact of the matter is, budgets have always been out of control in the U.S. Congress. Frankly, I think the Congress made a quantum leap last year in reducing the Federal budget, even though those were merely cuts in planned increases in the Federal budget for 1982. So we did make an abrupt U-turn. I think it is probably the first time in a very long time that the U.S. Congress has reduced the budget. So my question is this: Should we have concentrated only on reducing the size of the budget for 1982 and 1983 and set aside the tax cuts that we enacted in the last Congress?

Dr. TAUB. Two points: The first point is, if we think of the revenue side as 50 percent of the budget, and the expenditure side as 50 percent of the budget, we did not make an abrupt U-turn on 100 percent of the budget. We made an abrupt U-turn on 30 percent of the expenditure side or 30 percent of 50 percent, which means we only made a U-turn on about 15 percent of the budget.

Mrs. SNOWE. For 1982?

Dr. TAUB. For 1982.

Mrs. SNOWE. But not in the long run. By reducing the budget by almost $40 billion we have actually reduced Federal spending by $130 billion over the next 2 or 3 years.

Dr. TAUB. That's right, but the revenue side was expanded. Also, defense was expanded, and the rest of the budget, social security, wasn't touched at all.

Mrs. SNOWE. I agree, and I have some differences, with the administration on what tax cuts we should have enacted; but, what mystifies me is how the finance community, the business community, has responded, overall, to the program. It surprises me because the Congress really has made an abrupt turn, maybe not in figures, but has made the turn in awareness. I can't believe that the Congress has been so deficit conscious this year. That is an abrupt U-turn, just in expectations of what the Congress can at least produce and consider in the next few months.

Dr. TAUB. I do believe the thrust of the Reagan program was sound. He did isolate one problem, which was that nondefense expenditures were out of control.

Mrs. SNOWE. Right.

Dr. TAUB. He did isolate another problem, which was that business taxes were too high and that personal taxes were too high and rising. I would not say we would be better off had we not done anything last year. On the other hand, the program that we adopted was much too severe. I guess I might ascribe greed in this case. The business tax cuts, I think, were too large. We decimated the corporate income tax.

The personal income tax cuts, I think, were also too large, and the expenditure cuts were too highly concentrated in one area and only addressed one portion of the problem.

Mrs. SNOWE. Well, would we have been in a better position had we just enacted the President's original tax package, which was accelerated depreciation and individual tax cuts? That would have saved $60 billion off the bat.

Dr. TAUB. That's right.

Mrs. SNOWE. It was a $690 billion program, and we added $60 billion worth of tax cuts, and probably that is not even an accurate figure because I think we underestimated the anticipated loss of revenues from IRA's or all savers certificates. People are going to be taking advantage of those, I think, much more than we had originally anticipated.

Dr. TAUB. That's right. The worst features of the tax law change were things that were added, including indexing, in particular, but also some of the other charges.

Mr. MARRIOTT. I didn't get the answer to that question. Would you yield?

Mrs. SNOWE. Yes, I will.

Mr. MARRIOTT. Where would we be now had we just concentrated on spending cuts and not had a tax cut? What would be the interest rates and what would be the deficit projections? How much would they be different from what they are now?

Dr. TAUB. I want to take the easy question first. Interest rates would be substantially lower. Again I would have to work through the calculations. It strikes me that if we did not have the tax cuts at all, the budget would probably be in deficit right now, probably about $60 billion today, but that the 1983 budget would be very close to in balance and perhaps even in surplus, even with lower growth in the economy, because we didn't have that fiscal stimulus. Real interest rates, I think, would probably be 2 or 3 percentage points, which is the top end of the historical range.

Mr. MARRIOTT. So, in essence, you are saying the tax cut is the culprit for our economic woes; we would have been better off to get the budget balanced and then come back later and discuss the tax cuts?

Dr. TAUB. The unbalanced nature of the program was the cause of the woes. That could have been less of a tax cut or no tax cut at all, or it could have been more expenditure cuts, maybe less defense growth and some cuts in social security.

Mrs. SNOWE. To follow that up on the tax cuts, do you include in your graphs or your considerations, in projecting what the future

interest rates will be, the effect of the savings and investment provisions that we passed in the last Congress, such as the IRA's, or the all-savers certificates? These are the items that will encourage people to set aside their money rather than spend it. Will that make a difference in the interest rates in the long run?

Dr. TAUB. I don't think the specific savings incentives will have a significant impact upon savings. Let me work through the arithmetic on IRA's, for example.

If IRA usage triples between 1978, the last year for which we have data, and next year—twice as many people are eligible, but let's say IRA usage triples, which is actually reasonable because it is more widely advertised now—that will result in inflows of approximately $16 billion. Of that the Federal Government would return approximately $5 billion in reduced taxes, so the maximum total increase in savings is in the range of $10 billion.

Now, we must examine how much of that is new savings. The question is, if half of it is new savings and half of it is asset transfers, does that mean we have increased savings by $4 or $5 billion? The answer is, no.

Let us take an individual. Suppose you had planned to save $1,000 and because of the new IRA's you now save $2,000; you have increased your savings by $1,000, but your tax refund, if you are in the 35-percent bracket, is $700, so your net increase in savings is only $300.

So that means the likely increase in savings as a result of the IRA's, if we make some reasonable assumptions about the amount which is saved and the amount which is transferred assets, the maximum increase in savings would be $2 to $3 billion.

Mrs. SNOWE. All right, thank you. Thank you, Mr. Chairman.

Mr. NOWAK. Thank you very much.

Mr. Roemer, the gentleman from Louisiana.

Mr. ROEMER. Thank you, Mr. Chairman.

I appreciate your testimony. I appreciate the fact that you isolate a couple of variables that may be floating through the room and maybe through the world, and for my edification, first let us discuss the Fed policy.

I am trying to differentiate between the cause of the recession and the solution to our current problem, and know that emotions run high. But from my vantage point, although somewhat parochial and narrow, it seems to me the Fed in terms of blame takes a large share of blame for the cause of the recession. In terms of its second and third quarter policies in 1981—extremely tight money—in fact, in some statistical analyses, no growth in money supply at all.

Would you agree that although the Fed can take a disproportionate share of the blame for having a recession in the second and third quarters of 1981, that same analysis doesn't mean that loose money is the solution given where we are now? Would you agree with that, simply stated?

Dr. TAUB. Yes.

Mr. ROEMER. All right. The second narrow point: Tax cuts or tax increases versus spending cuts or increases.

I think you have already said that the thrust of the administration's concern is with the statistical fact that disposable income,

the percentage given to tax payments, local, State, and Federal, had increased in the last 10 years from 15 percent of disposable income up to 40 percent, and that some tax relief in terms of savings and investment was needed, but that given a static spending pattern, that is, loose fiscal management, tax programs went too far too fast. My question is, what would you prefer now as an economist, dealing with spending patterns or dealing with tax patterns? Which would you prefer, an economic approach that dealt with excessive spending or an economic approach that dealt with tax increases? What do you think would be best long term for the economy, increased taxes or spending management?

Dr. TAUB. There is a tradeoff between equity and efficiency inherent in the question. In terms of pure economic efficiency, one would like to keep the tax reductions and cut spending absolutely as much as possible. That certainly is short-term efficiency.

To balance that one would look at the extent to which the expenditure patterns are in fact investment in human capital, one would like to look at some equity arguments, and also what we want to do as a society. I can speak as a professional about the size of the budget deficit, but in saying what portion we ought to squeeze or not squeeze, the prime arguments are not economic.

When we get to very high marginal tax rates, I would say, above 45 percent, then the economic efficiency arguments become dominant. That is the thrust of supply side economics. When the tax rates are approximately 45 percent and below, it is mostly a social question, I believe.

Mr. ROEMER. So you are telling us, as I hear you—and I don't want to put words in your mouth, so you can correct me—as I hear you, you are telling us the Fed could be whipped in 1981, but you think that their policy is both constrained and constructive in 1982? No. 2, that if it is a loose fiscal policy that is our problem now, namely a deficit, we have to be willing to tackle both spending reductions where appropriate and equitable and tax increases where appropriate and equitable, and you don't think the deficit can be whipped without looking at it both taxwise and spendingwise 1982 and beyond? Is that true?

Dr. TAUB. With regard to the second half of your statement, I agree the numbers are too large to look at it just one way or the other way. The only point that I would take any objection to at all in your statement is the word whipped, which strikes me as a very strong word. The Fed is a little bit too tight now; it was much too tight in 1981.

Mr. ROEMER. Do you think it is too tight in 1982?

Dr. TAUB. Given the present circumstances, no. However, there should be some accommodation where less of an apparent budget deficit was traded off for easier monetary policy.

Mr. ROEMER. Right. I will leave it by saying that I agree with you that in 1982 the Fed is not too tight if we can show them some constructive measures to reduce the deficit 1983 and beyond; then they can legitimately, without raising the cost of interest, loosen up on money.

Dr. TAUB. Yes.

Mr. ROEMER. All right. Thank you very much for being here; I appreciate it.

Dr. TAUB. Thank you.

Mr. NOWAK. Thank you very much. We appreciate not only your written statement, but your very valuable and frank discussion here today.

Dr. TAUB. Thank you.

Mr. NOWAK. This is a topic that is not going to end very soon, and we will be, I am sure, back with you on many occasions.

Dr. TAUB. Thank you, Mr. Chairman.

Mr. NOWAK. Your next witness will be from the National Home Furnishings Association, Mr. Gerald Wolf. Mr. Wolf, will you come forward?

Mr. Wolf is the president of this association and is also the president of Wolf Furniture Enterprises located in Altoona, Pa., which I understand is a very old and well-established family firm. Mr. Wolf, once again, I might just say that your total written testimony will be inserted in the record, and you may proceed as you desire.

TESTIMONY OF GERALD P. WOLF, PRESIDENT, NATIONAL HOME FURNISHINGS ASSOCIATION, ACCOMPANIED BY VICKIE ERICKSON, DIRECTOR, GOVERNMENT AFFAIRS; AND GERALD NAGY, VICE PRESIDENT, GOVERNMENT RELATIONS

Mr. WOLF. Thank you, Mr. Chairman. This is Vickie Erickson and Gerald Nagy from our Washington government affairs staff who are assisting me. I will summarize what I have to say, and so it will be a little bit jumpy.

High interest rates make it extremely difficult for the retailer to finance the inventory which he needs to carry to attract customers. Those same high interest rates, coupled with the recession and uncertainty of the unemployment picture, are keeping many customers out of our showrooms, further exacerbating the plight of the home furnishings retailer.

High interest rates and consumer bankruptcies are of vital concern to our industry because they both contribute to the high cost of consumer credit. According to our association business surveys, approximately 60 percent of all sale in our industry are financed by some sort of credit. Here I might say that in the particular part of the marketplace that our company serves, which is the popular price, at least 75 percent of our accounts are financed on the installment basis, and so the cost of money becomes of greater concern.

Retailers who carry their own accounts are crushed between the tremendously increased costs they must pay for credit services and the limit on finance charges they may legally collect. Retailers who have used third parties for financing customer credit sales have found that most banks and finance companies have abandoned retail credit for more lucrative markets. As a result, of course, our funds for financing accounts are drying up. Of the few who are still involved, many are charging the retailers as much as 10 percent of the amount financed, and all have much more restrictive credit granting policies.

What that means basically is that if we are able to have a customer agree to have a third party financer on a $1,000 account and the financer is not getting enough carrying charges in the particu-

lar State, he is going to charge us anywhere from between 2 percent to 10 percent on a purchase of to $1,000, so we might receive between $900 and $980 for a $1,000 sale to a customer.

For the small retailer without in-house credit whose financing company now refuses contracts and the small retailer with in-house credit who can no longer afford a bank loan at rates considerably above prime to cover his accounts, the future is frightening indeed. Small businesses are closing their doors or facing bankruptcy as they watch sales fall, simply because they cannot offer financing to their customers who need it.

I might add here that many of these retailers are those who sell to lower income customers because that customer needs credit and pays by the month. That customer is more likely to ask what his monthly payment is rather than how much the total bill is. In other words, they are concerned with how much they must take out of their monthly budget. Therefore, keeping rates low is forcing the lower income customer out of the market. Just the opposite effect is desired by proponents of lower rates.

There are many causes of this, and you can see the logic of it. When there is a given amount of financing available, the tendency is to go to the customer who is more able to pay, so the marginal customers, social security customers, that type of customer, are really virtually being forced out of the market.

At the present time, ceilings on interest rates for consumer-credit contracts are set by individual States. Most of these ceilings are unrealistically low. With prime interest rates in the 15- to 20-percent range, the cost of money alone is higher than many State ceilings. In addition, there are administrative costs associated with the extension of credit. The combined effect makes the extension of credit uneconomical, forcing those not using credit to share the cost through increased prices of all merchandise.

There I might add that competitive situations come into effect, and larger companies such as Sears and Penney's, and so on, who are more able to get lower-priced financing, bring pressure to bear on the small retailer to maintain retail prices at a lower level.

The time and effort required to change interest rate ceilings on a State-by-State basis is prohibitive to the small businessman and unrealistic given the urgency of the problem. Failure to correct the situation will not only decrease the amount of available credit, but jeopardize small businesses throughout the United States. So NHFA strongly supports interest rate deregulation.

Now, on the question of the consumer bankruptcy problem, which is a serious problem for us and increases our cost, let me say this: Increased bad debt expenses also contribute to the high cost of credit. In today's economy defaults by customers are increasing for two reasons. First, in a recessionary period or one of very slow economic growth, defaults are simply more common than in good times. Second, and more importantly, the recent Bankruptcy Code which went into effect in October 1979, has made it much easier for individuals to declare bankruptcy. Many retailers have found that with their old credit standards for granting credit, some of their former reliable payers are going broke. Personal bankruptcies in 1980 were up 82 percent over 1979, and the first 6 months of 1981 has shown an additional 21-percent increase. For instance, our

experience shows something like 200 bankruptcies last year, where before the law was passed we were looking at 6, 8, or 10 bankruptcies. Of course, that result is far beyond what the recession might have caused.

What is worse are the findings by the Credit Research Center of Purdue University that nearly 40 percent of those who filed for bankruptcy under Chapter 7, which allows the bankrupt consumer to repay virtually none of his debt, could afford to pay at least 50 percent of their nonmortgage debt over a 5-year period. In addition, 29 percent of the same group could have paid off all their debt over the same period. The next result of these increasing losses is that furniture retailers and third party creditors must be tougher than ever when deciding who is eligible for credit.

The loss to business has been staggering; it is estimated that more than $6 billion of consumer debt was discharged in 1981. The result is that the consumer who does not declare bankruptcy, who makes wise purchasing decisions and pays his bills on time and in full, is being asked to shoulder the costs which the retailers and other lenders of this country have been forced to wipe off their books.

There is legislation pending before the House Judiciary Committee which would go a long way toward correcting the inequities of the 1978 Bankruptcy Code. NHFA wholeheartedly supports this legislation. The essential feature of this legislation is to add a future income test to the criteria to be considered by the bankruptcy courts in ruling on a consumer petition. The current code looks solely to present assets to pay debts.

So, concluding, without going into further detail concerning interest rate deregulation and bankruptcy reform, let me close by saying that these are two areas that could greatly assist the retail furniture industry in surviving these difficult times. We urge Congress to take positive action on both these issues.

It is also fair to say, however, that even immediate relief on these issues is not enough to ensure our industry's well-being. The problems of the retail furniture industry go beyond interest rate deregulation and the need for bankruptcy reform. Our problems, unfortunately, are rooted in the current management of our Nation's economy.

There is no way the long-term financing capability of any retail furniture enterprise can be assured as long as the Federal Government continues to crowd the money market with record deficit spending. There is also no way a small store owner can finance his day-to-day operating costs if Federal banking policies continue to allow local financial institutions to be gobbled up by large, impersonal conglomerates. What is worse, there is virtually no hope for improvement if the economic managers in the Federal Government refuse to recognize these problems in the hope that they will simply go away unnoticed.

As president of the National Home Furnishings Association, I can tell you that the problems I have just enumerated are what is on the mind of the typical retail home furnishings store executive.

We need the help of Congress in enacting legislation which will encourage sound, free economic principles.

Mr. Chairman, I thank you very much for the opportunity to make this statement.

[Mr. Wolf's prepared statement follows:]

PREPARED STATEMENT OF GERALD P. WOLF, PRESIDENT, NATIONAL HOME FURNISHINGS ASSOCIATION

Mr. Chairman and distinguished members of the Subcommittee, my name is Gerald Wolf and I am President of Wolf Furniture Enterprises, Inc. of Altoona, Pennsylvania. Our firm was founded by my grandfather 80 years ago and I succeeded my father in managing our 22 stores. The merchandise carried in our stores consists of furniture, home appliances and carpet.

In addition to operating furniture stores I am also President of the National Home Furnishings Association (NHFA) which represents voluntary membership of over 13,000 independent home furnishings stores located in all 50 states and the District of Columbia. Members of the association are primarily family-owned, single store operations with typical sales of under $1 million per year. It is interesting to note that of all the home furnishings sold at retail in the United States, an overwhelming majority, more than 80 percent, is sold in NHFA-member stores.

NHFA appreciates this opportunity to testify before this Subcommittee to discuss the current economic condition of our industry. Simply put, the condition of our industry today is frightening. Home furnishings retailers are caught in the middle of several problems which all seem to converge. High interest rates make it extremely difficult for the retailer to finance the inventory which he needs to carry to attract customers. Those same high interest rates, coupled with the recession and uncertainty of the unemployment picture, are keeping many consumers out of our showrooms, further exacerbating the plight of the home furnishings retailer. And, of the customers we do have, an alarming number have chosen the "easy out" of personal bankruptcy to solve their real or imagined financial problems.

High interest rates and consumer bankruptcies are of vital concern to our industry because they both contribute to the high cost of consumer credit. This is critical to understand because credit is the lifeblood of the retail home furnishings industry. According to our association business surveys, approximately 60 percent of all sales in our industry are financed by some sort of credit. NHFA's 1981 Annual Operating Experiences Report reveals the following distribution of home furnishings sales:

	Percent
Cash	43.0
Bank cards	4.5
Third-party credit	8.3
In-house credit	44.1
Total	100.0

OVERVIEW OF THE RETAIL CREDIT CRUNCH

Since nearly all retail furniture stores extend some form of credit, the financed customer sale has been the central method for the consumers to purchase retail home furnishings. Whether they are buying basic household furnishings or acquiring furnishing to maintain their standard of living, customers expect to be able to finance these major investments, just as they would an automobile or a home. Historically, the home furnishings retailer has been able to fulfill this expectation, either by financing the sale himself or by assigning the credit contract to an outside source such as a bank or finance company.

Of course, the retailer incurs many administrative costs in carrying his own accounts. These include forms, postage, stationery, equipment, additional personnel, losses on bad accounts, and interest paid on monies borrowed to continue his business operation while repayment is being made by the customer. If the retailer cannot absorb these costs with the finance charges collected on credit sales, these costs must be deducted from any profits gained from the sale of goods.

Thousands of home furnishings retailers are facing financial extinction today. Retailers who carry their own accounts are crushed between the tremendously in-

creased cost they must pay for credit services and the limit on finance charge rates they may legally collect. Retailers who have used third parties for financing customer credit sales have found that most banks and finance companies have abandoned retail credit for more lucrative markets. Of the few which are still involved many are charging the retailer as much as 10 percent of the amount financed, and all have much more restrictive credit-granting policies.

Fair competition, which is essential to keep consumer prices reasonable, is reduced as small businesses are forced go give up "in-house" credit, and are denied equitable outside sources. There is a resultant drop in sales and market share, which is picked up by larger businesses which have the financial resources, or compensating out-of-state outlets, to temporarily withstand the impact of the "credit crunch."

For the small retailer without in-house credit whose finance company now refuses his contracts, and the small retailer with in-house credit who can no longer afford a bank loan at rates considerably above prime to cover his accounts, the future is frightening indeed. Small businesses are closing their doors or facing bankruptcy as they watch sales fall, simply because they cannot offer financing to their customers who need it.

Why don't home furnishings retailers follow the trend and accept bank credit cards? Many of them do, but this does not solve the problem. A home furnishings purchase can be a major investment, and any bank card has a credit limit which may not cover the entire purchase. Even if it does, most customers are reluctant to use their entire line of credit for one purchase. Also, bank credit cards do not offer the extended payment plans which customers may prefer for major purchases.

The most important drawback to bank credit cards is that many credit-worthy consumers, particularly families in low income brackets, cannot obtain them. Home furnishings retailers traditionally provide credit to a much wider range of consumers than do banks. The credit that the retailer can arrange or provide for these consumers is often their only resource for financing essential purchases.

To cope with unreasonable finance charge rate limits, retailers must raise prices, reduce services, or discontinue offering credit. Each of these choices has an adverse effect on the consumer.

When prices are raised to cover credit costs, the cash customer is, in effect, subsidizing the credit customer. The cash customer is also penalized when a retailer is forced to discontinue services, such as delivery, or must charge an additional fee for them.

When credit is restricted, the low-income consumer is denied fair access to essential goods. Unable to purchase with a "lump sum", and unable to utilize store-arranged credit, he may be forced to borrow from illegal sources at exorbitant costs. Or, he may be forced to "do without" the merchandise he needs to buy—and the retailer needs to sell.

At the present time ceilings on interest rates for consumer credit contracts are set by individual states. Most of these ceilings are unrealistically low. With prime interest rates in the 15–20 percent range, the cost of money alone is higher than many state ceilings. In addition there are administrative costs associated with the extension of credit. The combined effect makes the extension of credit uneconomical, forcing those not using credit to share the cost through increased prices of all merchandise. The time and effort required to change interest rate ceilings on a state by state basis is prohibitive to the small businessman and unrealistic given the urgency of the problem. Failure to correct the situation will not only decrease the amount of available credit, but jeopardize small businesses throughout the United States.

NHFA strongly supports interest rate deregulation. With the current Federal and state disclosure laws protecting consumer interests, the built-in controls of the competitive marketplace will establish realistic pricing levels without forcing those who do not use credit to subsidize those who do. Since furniture purchases, as with most retail purchases, are made out of discretionary income and are always deferrable, failure to act will hurt both consumers and small businesses.

OVERVIEW OF CONSUMER BANKRUPTCY PROBLEM

Increased bad debt expenses also contribute to the high cost of credit. In today's economy defaults by customers are increasing for two reasons. First, in a recessionary period or one of very slow economic growth, defaults are simply more common than in good times. Second, and more importantly, the recent Bankruptcy Code which went into effect on October 1979 has made it much easier for individuals to declare bankruptcy. Many retailers have found that their old credit standards and "point scoring" techniques no longer apply. Some of their formerly reliable payers

and highest scorers are going broke. Personal bankruptcies in 1980 were up 82 percent over 1979 and the first 6 months of 1981 has shown an additional 21 percent increase. What is worse are the findings by the Credit Research Center of Purdue University that nearly 40 percent of those who filed for bankruptcy under Chapter 7 (which allows the bankrupt consumer to repay virtually none of his debt) could afford to pay at least 50 percent of their non-mortgage debt over a 5-year period. In addition, 29 percent of the same group could have paid off all their debt over this time period. The net result of this trend is that furniture retailers and third party creditors must be tougher than ever before when deciding who is eligible for credit.

The loss to business has been staggering. It is estimated that more than $6 billion of consumer debt was discharged in 1981. The result is that the consumer who does not declare bankruptcy, who makes wise purchasing decisions and pays his or her bills on time and in full, is being asked to shoulder the costs which the retailers and other lenders of this country have been forced to wipe off their books.

There is legislation pending before the House Judiciary Committee which would go a long way toward correcting the inequities of the 1978 Bankruptcy Code. NHFA wholeheartedly supports this legislation. The essential feature of this legislation is to add a future income test to the criteria to be considered by the bankruptcy courts in ruling on a consumer petition. The current code looks solely to present assets to pay debts.

CONCLUSION

Without going into further details concerning interest rate deregulation and bankruptcy reform let me close by saying that these are two areas that could greatly assist the retail furniture industry in surviving these difficult times. We urge Congress to take positive action on both issues.

It is also fair to say, however, that even immediate relief on these issues is not enough to ensure our industry's well-being. The problems of the retail furniture industry go beyond interest rate dereguiation and the need for bankruptcy reform. Our problems, unfortunately, are rooted in the current management of this nation's economy.

There is no way that the long-term financing capability of any retail furniture enterprise can be assured as long as the Federal Government continues to crowd the money market with record deficit spending. There is also no way a small storeowner can finance his day-to-day operating costs if Federal banking policies continue to allow local financial institutions to be gobbled up by large, impersonal conglomerates. What's worse, there is virtually no hope for improvement if the economic managers in the Federal Government refuse to recognize these problems in the hope that they will simply go away unnoticed.

As President of the National Home Furnishings Association I can tell you that the problems I have just enumerated are what is on the mind of the typical home furnishings store executive. As a witness before this Subcommittee, I ask that you do all that is in your power to address these issues not only within the Congress, but also with the Administration. We need friendly ears and responsive economic policies as urgently as we need interest rate and bankrupty relief.

Mr. Chairman, thank you for this opportunity to express the views of the retail home furnishings industry.

Mr. NOWAK. Thank you for taking the time, Mr. Wolf, to personally appear here. We know it is an imposition to come to Washington and to prepare extensive and very comprehensive testimony as you have done. We appreciate that, and we appreciate your input into this hearing.

Let me ask one question regarding inventory. It has been mentioned that there is such a backup of inventories; you look at the housing and you look at the auto industries, and I am wondering about your industry, the home furnishings industry. Everybody is anticipating great new growth and more production of goods and services in this country. One of the things that seems to be detracting from the new investment in new production and new machinery in taking advantage of the depreciation schedules that are now on line is huge inventories that are backed up in stores, in retail outlets, in warehouses, and even in manufacturers plants them-

selves, who are not going to be producing until that inventory starts to wear down.

If we don't have new housing or if we don't even have a way for people to sell the houses that they now have, they are not going to give up a 7- or 8-percent interest rate to improve their situation, and to make their house available. That, in turn, backs us right up into the home appliance business and certainly backs us up right into your business.

Do you have a feeling industrywide about the kinds of inventories that are presently out there?

Mr. WOLF. I can tell you our own personal experience, and then I can relate it to the industry a little bit.

Pennsylvania itself has been suffering the recession for a longer period of time, probably a year longer, than the rest of the country, so inventory cutting began with us 2 years ago. I would say that personally our company's inventory is in shape for the business that we are doing; we have reduced our inventory.

I would say that in areas where there has been recession—and, of course, that would be the automobile areas—those dealers have been cutting their inventories for 1½ to 2 years. In areas where the recession has hit more recently, those dealers would have larger inventories and would still be in the process of bringing their inventories in line with their sales.

Mr. NOWAK. The other day I received in the mail at my residence in Maryland a very large, well prepared brochure. This relates to this inventory question. It just happened that the brochure came from a manufacturer who is located in North Carolina, and that manufacturer in effect said:

> Don't buy anything retail! Don't go shopping! Or if you do go shopping, just get a number or whatever the identification would be, and send us the order directly or come and visit us, and we'll buy you a cup of coffee and sell you all of our furniture that is located in our plant at 50 percent savings.

Or whatever it was.

Not needing any furniture that day, I put that aside, and about a week later I opened up my mailbox and there was another notice saying:

> You haven't responded to our first invitation to come to our plant in North Carolina. It is only 5½ hours away, and in fact we have improved our services because we are now going to deliver the furniture to your apartment in Maryland. And again, please don't go shopping, and waste all your time and money in a retail outlet.

That brought the question to my mind: How much new inventory is there out there at the plant unsold? It seems that if you are going to get an inventory, you would get your inventories from their production.

Mr. WOLF. Well, there are two types of furniture stores generally, and, of course, one type—which we are—is the popular priced store. We have our furniture in stock to the customer. A mother-in-law is coming to visit, or there is a baptism or a christening or something and they need the furniture right away because something has broken down; that is the popular priced furniture.

There is also the special order business, which is not our specialty. That merchandise is not manufactured. That is manufactured after the order is received at the factory.

For instance, we have to take a gamble on the merchandise. We buy in stock because we feel we know what the customer is going to buy over the next 3 to 6 months.

So the merchandise you are asking about, the special order merchandise that has not been generally manufactured, will be manufactured after the order has been received. So that is not a specific inventory problem, generally not a specific inventory problem for the manufacturer.

Mr. NOWAK. All right. We have the other problem then that you have or that you run into, and that is, I would think, the same as that of an automobile dealer who said to me, "You know, 60 percent of my cars are ordered and 40 or 45 percent are bought off the floor." That was done traditionally, and now, he says, because of the inventory or the cost of carrying inventory, he only has two or three cars. Therefore, he is losing a large percentage of that walk-in trade which is looking for a specific car, and he says, "Of course, now we can not afford to keep it on the lot."

So you are caught in that double situation.

Mr. WOLF. Yes. In defense of the manufacturers, I must say that they have to keep raw material in stock, which is their basic inventory, and they have to finance that, too, so it is not peaches and cream for the manufacturer at all.

Mr. NOWAK. Right. Thank you.

Mrs. Snowe?

Mrs. SNOWE. Thank you, Mr. Chairman, and thank you, Mr. Wolf, for being with us here today.

In answer to one question, you mentioned in your testimony that you advocated interest rate deregulation. You also mentioned the fact that there had been an increased number of bankruptcies. The increase in the number of bankruptcies for 1980 was, I believe, 82 percent over 1979.

Mr. WOLF. In 1980?

Mrs. SNOWE. Am I saying that correctly?

Mr. WOLF. Yes, right.

Mrs. SNOWE. Bankruptcies increased 82 percent in 1980 over 1979.

Would you tell me, with interest rate deregulation, if that happened, would it not exacerbate the number of personal bankruptcies that could occur in this country if you raised the ceiling, for example, from 20 to 25 percent or eliminated the ceiling altogether?

Mr. WOLF. Well, once again I have to give an example from our own experience. We sell a customer, say, from $700 to $1,000, and in Pennsylvania the limit is 15 percent, and so we are going from 15 percent. Right now there is legislation pending that would take it to 18 percent; 3 percent on $800 would be $24 a year or $2 a month. I don't think that $2 a month is going to cause the customer who is buying on credit to have financial difficulties, but cumulatively, over our entire customer base, that is going to help us survive in difficult times.

Mrs. SNOWE. I understand your perspective. It is just that so many people are caught in a bind financially and are generally on the threshold; many people have overextended themselves creditwise. Adding additional increases in interest rates as a result of

the deregulation, and upping the ceiling on interest rates, could push somebody over the edge. They may have purchased something from one store and they may have purchased a car or something else. Cumulatively, it could have a detrimental effect if you were to deregulate the interest rates. That is a positive effect as a result of that.

I understand that many people are overextended on credit so that could impose additional pressure in that direction.

Mr. WOLF. Well, if the $2 is going to bring him closer to bankruptcy, that's true.

Mrs. SNOWE. I don't think it would except maybe in an individual situation. But, if they purchased a car or other large item, there could be a number of different things that could happen, because what you are saying is that with interest rate deregulation there would be no ceiling.

Mr. WOLF. On the other hand, the alternative is that that person is virtually forced out of the market because they are not going to get the credit anyway. They are either going to have to not buy, which is the general thing, or they are going to have to reduce the amount of buying, but the credit won't be available for that customer because the retailer cannot afford to sell the merchandise on that basis.

Mrs. SNOWE. What would happen if you turned a lot of customers away because credit was not available?

Mr. WOLF. What we usually do—and it is a question of personal negotiation—is reduce the amount of purchases when we run into that problem, and they get something that they can manage on a monthly basis.

Mrs. SNOWE. Are you saying that more people who would want to use credit are paying cash?

Mr. WOLF. Our personal experience, where 80 percent of our business is credit, is, you know, that it is still——

Mrs. SNOWE. Still the same?

Mr. WOLF. Yes, still like that, yes.

Mrs. SNOWE. Thank you.

Mr. NOWAK. Thank you, Mr. Wolf, for taking the time here and bringing your trials and tribulations to the forefront before this committee. Again, we will continue this inquiry into this whole area and, hopefully, start to reach some positive solutions as we grapple not only with the budget but with the two important pieces of legislation that you mentioned.

Thank you very much.

Mr. WOLF. Thank you very much for the opportunity.

Mr. NOWAK. I also want to thank the staff for being very, very cooperative with the counsel for this committee.

We have an opportunity to conclude a little after 12:30, and instead of asking the last two organizations to come back at 1:30, and take more of your afternoon, I wonder if we could panel the last two associations, who I think have some similar testimony and also have contributed greatly to this committee in the past and whose statements really do speak loud and clear. So if we could have the Southeastern Lumber Manufacturers Association, which is represented here by Mr. Doyle who is the past president and the current director of this organization, and is the president of Doyle Lumber

Co., in Martinsville, Va., and the other group, the National Small Business Association, Fred Schoenfeld, who is a member of the board of trustees of NSBA and the founder and owner of Select Brand Industries in Kansas City. He is accompanied by Jerome Gulan, who is the vice president of government affairs here, who has been very cooperative with this committee. I hope that we can summarize your testimony and allow you to leave.

So, Mr. Doyle, if you would like to make your presentation first.

TESTIMONY OF WILBUR S. DOYLE, DIRECTOR, SOUTHEASTERN LUMBER MANUFACTURERS ASSOCIATION, ACCOMPANIED BY THOMAS CATOR, STAFF MEMBER; FRED SCHOENFELD, MEMBER, BOARD OF TRUSTEES, NATIONAL SMALL BUSINESS ASSOCIATION, ACCOMPANIED BY JEROME GULAN, VICE PRESIDENT OF GOVERNMENT AFFAIRS

Mr. DOYLE. Thank you, Mr. Chairman.

I remember that the last time I was here, I was somewhat apologetic that I could talk about the problem and I had no solution, so I am going to spend very little time today talking about the problem, which is very obvious by what has been said that you are pretty well aware of the problem.

I would like to pinpoint it a little bit by telling you my own personal reference. I am a first generation company, starting immediately after getting out of the service, and out of college.

During the past 4 years, we have averaged a 26-percent growth during that period of time; we have increased profits sharply during that time period. We last year paid about $80,000 in taxes; this year I expect to get back $100,000 because of losses. This is the budgetary impact that we are talking about here today; it is the type of thing that is happening to us.

We had plans to make a major expansion. Now our contingency plans are on hold, to where supervisors are doing line work, to be sure that we keep everything in place until this storm passes by. So I just want to point that out on an individual basis, that I do understand it.

I want to say also that my concern—and I hope your concern—in Congress—is compassion for these people. I am going to make it. I have been in business 34 years. I have had the opportunity to put some reserves away to make it. But I can tell you, quite frankly, that fine young companies are going down the drain today, not because they are poorly managed, but because of a sudden change in policy.

Now, I want to say that we are not against the policy. Most of us out there believe that the long-term goals that are being activated in Congress and by this administration are basically sound. But as I tried to describe it to somebody the other day, I said, "If you put the children on a pickup and head to town, you have headed to the right place, but if you turn the curve too fast, you create casualties."

We have got a lot of good young people out there who have been in business 10 to 12 years, the future productive sector of this Nation, that cannot survive where we are.

You know, if interest rates are 10 percent and you can't pay out of debt—it is not discretionary—when they go to 20, you just can't meet the payments, and you go under.

So it is discretionary for people to have access to capital who can decide, "Will we do this expansion now? Will we buy out this young company that is in a cash-flow squeeze right now?" It is discretionary in that line, but it is not in the other.

Now, I am convinced that the proposal that I have for you here today can do just what I claim in the front page of the thing. If you would turn over to the proposal, which is about halfway through my testimony, "A Proposal to Improve the Effectiveness of the Administration's Economic Recovery Package," I would just like to read that one paragraph, and then I will do it for you: "Persistent high interest rates coupled with a tight monetary policy are having a strong effect on efforts to improve productivity. Continued sluggishness in the economy and an increase in the number of unemployed are further increasing the Government's deficit and subsequent need for additional borrowing" by the Government. This proposal could reduce the Government's need for borrowing by over $20 billion in the first year, and reduce unemployment by nearly 1 million people and help the dynamics of productivity necessary for a healthy recovery of our economy.

Somebody said here today that small business is tied closely to housing. I would like to suggest to you that the soundness of the economy of this Nation is tied closely to housing. That is the point I am trying to make. Now, there are four facts that I would be using as a basis to try to prove this statement on the front page.

First, Treasury estimates that for every million people unemployed, between $25 billion and $29 billion has cost Treasury in lost revenue and increased payouts; that is a Treasury figure.

There are at the present time in excess of a million people unemployed in the construction and construction related industries; that is a stipulated fact.

Last year, when this was written, I was waiting for the end of the year, since we said there would be approximately 1 million houses built; there were in fact 1.086 million, I believe, built.

I say now that, with the things that are in place, we will build less than that this year instead of recovering.

I have just been to a number of places, like the Forest Industries Advisory Council, where the best economists in the industry are projecting and their feeling is it might go 850.

So we don't see the improvement this spring we had hoped for. We believe that there is great pent-up demand for housing and that the major deterrent is mortgage rates. There has been a great deal said here today about interest rates coming down. Short term interest rates have come down, but mortgage rates have done very little.

Let me say this one thing, because it won't happen often before you. This is not a subsidy. I know somebody will take issue, so I want to define it as Webster: "A monetary assistance granted by a government to a person or private commercial enterprise."

I would contend that it is not a subsidy. In fact, it prepays itself. The proposal would create a 2-year Federal program designed to

stimulate new housing by making the first year interest earned on those loans tax exempt for the full 30 years of it. The second year, 50 percent and dead.

The reason for that is that you get so many programs that go on and on and on. This one has a self-liquidating feature built into it.

Now, the mathematics of that problem are spelled out over there, but basically here is what happens:

The budget bureau, the Congressional Budget Office, took this, and they said that it could cost $1 billion to do this in the first year. It could cost one-half billion the second, when you project it out. Now, let me try to bring it down to simple facts. We have a million people unemployed, and because they are unemployed Treasury is going to lose between $25 billion and $29 billion in receipts and payouts.

My proposal says, "Let's build one-half million houses by making interest rates affordable," which you reduce the rate by about 2½ percent, according to CBO, in the range from 17 to 18, it brings it into the 12 to 14 range, whether it is 70 to 80 percent from 2½ to 3½ points. With that, everybody in the industry that I have discussed it with says that we would build one-half million extra houses.

On this proposal, what we would do is we would take the money, which is about $30 billion as far as congressional money is concerned; about the same amount of money, between $25 billion and $29 billion, and put three-quarters of a millon people back to work, and they would begin to pay taxes, buy furniture, buy cars, and so on.

The first time the Government would be called on to give up anything would be after these people had worked, after the house had been built, after the lending institutions had reached the end of its fiscal year and filed their tax return. Then they would take this credit.

Now, if you take the $1½ billion and project it out over the 30 years, the total cost of that is $22 billion in 30 years.

The total saving to the Treasury for three-quarters of a million people to go back to work next year is $20 billion.

So I am saying to you: Here is an opportunity not to subsidize something. It will literally subsidize the budget next year by saving the Government from borrowing this $25 billion to $29 billion; we would build these houses. You would put three-quarters of a million people back to work. You would reduce the Government's loss of revenue by over $20 billion. You would reduce their necessity to borrow money by that amount, thus taking some pressure off the inflationary spiral, and you would accomplish all these things without hiring one new Federal employee, because everything is in place. The banks or the lending institution, when they get to the point of making the loan, they simply put it in the same category that they would any other tax exempt product, and you would, in the meantime, add over $200 billion in structures that the counties and cities badly need as taxable properties; this would do that for them.

Now, the prompt adoption of this short-term policy, and what this proposal is for is not a long-term thing. What I am trying to do is to figure out a way to soften the blow of this change in direction,

this current recession, just enough to get the economic vehicle moving.

With the prompt adoption of this, in my opinion, the depth and duration of the present recession could be favorably affected, thus making it possible for many small businesses to view the next few months as a transition rather than a tragedy. For many of them, the limit of their endurance has been reached. Bankruptcy rates are already soaring, and the short-term program could furnish the impetus so badly needed to start our economy on the road to a healthy recovery.

Mr. Chairman, I would simply say to you, in conclusion, that, regardless of how good the long-range program is, self-preservation is the first law of nature. I do not think it realistic to expect people to continue to support a good long-range program in which they cannot survive the transition.

[Mr. Doyle's prepared statement follows:]

PREPARED STATEMENT OF WILBUR S. DOYLE, PRESIDENT, DOYLE LUMBER CO., ON BEHALF OF SOUTHEASTERN LUMBER MANUFACTURERS ASSOCIATION (SLMA)

Mr. Chairman and members of this committee: My name is Wilbur S. Doyle, President of Doyle Lumber Company in Martinsville, Virginia. I am appearing here today as a former President and current Chairman of the Governmental Affairs Committee of the Southeastern Lumber Manufacturers Association, headquartered in Forest Park, Georgia. SLMA was founded in 1962 by a group of independent small business lumber manufacturers for the purpose of solving industry problems. It currently has an active membership of 394 small business lumber manufacturers located in 12 Southeastern States, making it the largest regional association of its kind in the nation. The combined production of our member mills is approximately three billion board feet annually.

Mr. Chairman, to get right to the heart of the matter, record high interest rates are having a devastating effect on new housing starts which in turn has caused a genuine depression—not a recession—in the construction, furniture, and lumber manufacturing industries. Members of SLMA, all of whom are small, independent operators, fervently believe in the free enterprise system. They are eager and willing to do their part in helping the country get back on its feet economically. Our problem is that it is unrealistic to ask our support of government long-range monetary and fiscal policies if in the interim, short-term corrective measures drive us out of business. I might add that the weak operators in our business vanished from the scene long ago, so I'm speaking today only for the very best, most efficient producers who are trying to stay alive until long-term interest rates come back down and there is a rebound in new housing starts.

To illustrate the independent lumber manufacturers' predicament, I would like to give the Committee a personal perspective. From 1975 through 1979 Doyle Lumber, Inc. experienced an annual sales growth exceeding 26 percent and an annual increase in profits of 60 percent. Since the onslaught of high interest rates and the correlating decrease in housing starts beginning in 1979, net sales have slipped 10 percent and profits have now disappeared completed. Even in the environment of 1.3 million starts in 1980, Doyle Lumber, Inc. earned in excess of $200,000 and paid approximately $80,000 in income taxes. However, for year end April 30, 1982 in which housing starts barely exceeded 1.1 million, we foresee a loss of over $200,000. We will be due a refund of $100,000, more than offsetting the taxes paid in the previous year for a total loss to the Treasury of $180,000.

We have gone from concrete planning of a major expansion which would have more than doubled our employment to implementing emergency cost saving measures just to insure survival. It is remarkable, and far from typical of the industry, that we have not had to lay off any employees. We have decreased the work week from 50 hours to 38 and operate at about 70 percent capacity.

In a broader perspective, according to a recent SLMA membership survey, lumber production is down 31 percent from a year earlier and lumber shipments are off 33.5 percent. In February, SLMA members reported a total of 2,833 workers laid off and 34 mills shut down.

I should add that more of the larger, non-SLMA lumber manufacturers have ceased operating than have SLMA member companies. That is because it is sometimes more costly for an independent to shut down, but it is primarily due to the fact that an owner will go to great lengths to keep his employees, who have been with him for years, on the payroll.

Last year, 28 SLMA member companies terminated their SLMA membership due to economic reasons. Fifteen of those former members have gone out of business permanently and ten were acquired by very large operators who found it an opportune time to buy out those well-run companies caught in a cash flow squeeze and without the capital resources to ride out the business cycle. These acquisitions are, on the whole, unfortunate from a public policy point of view as the larger concerns are less efficient and therefore the ultimate cost to the consumer for lumber products will be higher.

The state of our industry which I have just described can be attributed entirely to high interest rates and the debilitating effect they have had on the demand for lumber. But Mr. Chairman, I am not appearing today just to discuss the economic crisis in the lumber manufacturing industry. I would also like to suggest a solution to it. Our proposal, a copy of which is attached, has been endorsed by the Virginia Chamber of Commerce and would create a 2 year Federal program designed to stimulate new housing starts by reducing mortgage interest rates. Under the proposal, interest received by a lender from a mortgage made on a new existing, unoccupied home or on a newly constructed home would be taxed at reduced rate. This would enable lenders to offer discounted or reduced mortgage rates on those loans.

For example, in the first year of the program, First City Bank makes a mortgage loan to John Doe. The interest First City Bank received on that loan over its duration would be tax free. In the second year of the program, First City Bank makes a loan to John Brown. The interest received by First City would be 50 percent tax free over the duration of the loan.

Since lending institutions generally make tax-exempt loans at 70 to 80 percent of the corresponding taxable rate, we believe this proposal would reduce fixed mortgage rates to a level of 12 to 14 percent.

The best information available indicates that with a 12 to 14 percent mortgage interest rate, housing starts would increase to 1½ million per year. This would reduce unemployment in the construction industry by more than 750,000 persons and reduce the Federal Government's borrowing requirements by $19.4 to $22.5 billion.

The cost of the program would be approximately $1 billion per year according to an evaluation received by Senator John Stennis from the Congressional Budget Office.

Mr. Chairman, we believe our proposal will pull housing out of its depression, reduce unemployment, reduce Federal borrowing requirements and increase the size of the local tax base. I would be pleased to further discuss it with you or your staff.

A PROPOSAL TO IMPROVE THE EFFECTIVENESS OF THE ADMINISTRATION'S ECONOMIC RECOVERY PACKAGE

(By: Wilbur S. Doyle, President, Doyle Lumber, Inc., Route 4, Box 339-A, Martinsville, VA 24112. Member of the Small Business Council of the Chamber of Commerce of the United States; Former Member of the U.S. Treasury Small Business Advisory Committee; Delegate to the White House Conference on Small Business; Past President of the Southeastern Lumber Manufacturers Association. Date: November 9, 1981. Revised: February 8, 1982.)

Persistent high interest rates coupled with a tight monetary policy are having a strong effect on efforts to improve productivity. Continued sluggishness in the economy and an increase in the number of unemployed are further increasing the Government's deficit and subsequent need for additional borrowing. The proposal in this paper could reduce the Government's need for borrowing by over $20 billion in the first year, reduce unemployment by nearly a million people, and help the dynamics of productivity necessary for a healthy recovery of our economy.

The following are facts which are the basis of the discussion and calculations in this paper.

1. Treasury estimates loss of revenue and increased Federal payouts for unemployment benefits to be between $25 and $29 billion for each million persons unemployed.

2. There are at the present time an excess of 1 million workers in the construction and related industries who are unemployed.[1]

3. There will be approximately 1 million houses built in the United States in 1981.[1] It is doubtful the total number of units built in 1982 will equal 1981 under present programs.

4. There is great pent up demand for housing. The major force preventing a quick recovery of the construction industry is high interest rates.

PROPOSAL

The proposal would create a 2 year Federal program designed to stimulate new housing starts by reducing mortgage rates. Under the proposal, interest received by a lending institution from a mortgage loan made on a new, existing, unoccupied home or on a newly constructed home during those 2 years would be taxed at a reduced rate. This would enable those institutions to offer discounted or reduced mortgage rates on those loans.

For example, in the first year of the program, First City Bank makes a mortgage loan to John Doe. The interest First City Bank received on that loan over its duration would be tax-free. In the second year of the program, First City Bank makes a mortgage loan to John Brown. The interest received by First City Bank would be 50 percent tax-free over the duration of the loan.

DISCUSSION

Lending institutions generally make tax-exempt loans at 70 to 80 percent of the corresponding taxable rate. The proposal would allow lending institutions to offer reduced rate mortgages. Since the fixed mortgage rate is now about 17 to 18 percent, the proposal would reduce fixed mortgage rates to a level of 12 to 14 percent.

The best information indicates that with a 12 to 14 percent interest rate, housing starts would increase to 1½ million or more units per year. This would reduce unemployment in the construction industry by more than 750,000 persons and therefore reduce the Government's need to borrow to make up for $19.4 to $22.5 billion in lost revenue and increased spending for those unemployed. All this could be done for essentially the same amount of money demand. The only difference is it would be borrowed by the productive sector rather than the Government. By reducing Government borrowing, the proposal could help fight inflation. The dynamics of a healthy construction industry would also have a very positive effect on other related industries such as the lumber, automobile, furniture, and appliance industries.

The proposal stated in mathematical form is as follows:

Price of average home	$70,000
Percent borrowed (multiplied by)	.90
Amount borrowed on average home	$63,000
Increased number of units that would be built with favorable interest rate (multiplied by)	500,000
Amount of funds borrowed to build one-half million new homes	$31,500,000,000
Amount borrowed to build the 1 million homes projected for 1982 under present program	$63,000,000,000
Total amount borrowed capital required to build 1.5 million homes	$94,500,000,000

The revenue loss to Treasury on this magnitude of loans would be approximately $1 billion according to a response received by Senator Stennis from the Congressional Budget Office when he submitted this proposal for evaluation:

$1 billion times 30 year mortgage divided by 2 equals $15 billion lost on 100 percent tax exempt mortgages

$500 million times 30 year mortgage divided by 2 equals $7.5 billion amount of lost revenue on 30 year mortgage made in second year at 50 percent tax exempt

$15 billion plus $7.5 billion equals $22.5 billion total amount revenue loss for entire program for 30 years.

Therefore, the entire revenue loss to the Government for the 30-year life of the mortgage is no more than the estimated cost to Treasury for 750,000 people to be unemployed for 1 year.

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[1] Excerpted from the Statement of Mr. Frederick J. Napolitano of the National Association of Home Builders before the Subcommittee on Tax, Access to Equity Capital and Business Opportunities, Committee on Small Business, U.S. House of Representatives, Oct. 15, 1981, pp. 2 and 3.

CONCLUSION

This program could have the following desirable and helpful impacts on our economy beginning with the first year in effect.

1. Reduce unemployment in the construction and related industries by 777,000 people.[3]

2. Reduce the Federal Government's loss of revenue and increased level of spending because of higher umemployment by $19.4 to $22.5 billion.

3. Reduce the Government's necessity to borrow and thus reduce pressure on the inflationary spiral.

4. Accomplish all three of the above items without any significant increase in demand for capital or the addition of one Federal employee.

5. Add over $200 billion in taxable real property to the tax roles.

By the prompt adoption of this program, the depth and duration of the present recession could be favorably affected thus making it possible for many small businesses to view the next few months as a transition rather than a tragedy. For many of them the limit of their endurance has been reached. Bankruptcy rates are already soaring. This short program could furnish the impetus so badly needed to start our economy on the road to a healthy recovery.

Proposal presented:

November 10, 1981—Southeastern Lumber Manufacturers Association Board of Directors (Approved).

December 9, 1981—With the assistance of Senator Stennis to President Reagan's Economic Councilman, Mr. William Niskanen (Under Consideration).

January 21, 1982—The Executive Boards of the National Association of Home Builders, the National Forest Products Association, and the National Lumber and Building Materials Dealers Association in Joint Session (Under Consideration).

January 29, 1982—Virginia State Chamber of Commerce Board of Directors (Approved).

Mr. NOWAK. Thank you very much.

We have been trying, some way, over the past year, somewhat along the lines of your proposal, to try to see if there was some way when these rates started to just rise astronomically, if there couldn't be a method of targeting specific incentive. We use incentives for every kind of industry in this country, and we look with encouragement at the homebuilding industry, which is one of the prime movers, when you look at the interest rate deduction on mortgages, which is in the tax code.

Last year, when we were going through with the initial phases of the tax cuts, one of the revenue enhancers that was discussed by OMB and one of the suggestions made was the Ways and Means Committee should take a look at the deduction on home mortgates, and if that were eliminated we would raise $38 billion to reduce the deficit. The projection at the time that proposal was made was a $43 billion deficit, and with one act and one line out of the Ways and Means Committee we could have eliminated $38 billion of that $43 billion and, theoretically, had a balanced budget in fiscal year 1982.

That, however, was deemed politically unpalatable and so everybody just walked away from it. On the one hand we are saying we have got to encourage home building, we have got to encourage people getting into that first equity position, we have got to upgrade the quality of life for people, we have got to give them at least the opportunity to participate on that level. Even if they never buy a share of stock, at least they have got something growing in this country.

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[3] National Association of Home Builders Economist.

We talked about trying to target. We made a suggestion for a two-tier rate, which is somewhat similar in effect, that would be given to certain segments of our small business community and the homebuilding community. If somebody went in to borrow money, whatever the prime was, they could be given a differential if the money were used not for consumer credit generally, but if they were going to buy a home or they were going to invest it in a small manufacturing operation, that would have a lower so-called prime. We were trying to encourage them to use and eliminate the reserve on the money that the bank would normally be required to hold, to give them the incentive to use the differential. To some degree that was used administratively during the Nixon administration when the rate started to go too high, and the encouragement was given to the Fed, and the Fed did encourage the member banks to target more closely the so-called productive loans in the economy. So we appreciate your suggestion here, and I feel very strongly that a large part of our recovery stems from this blockage in homebuilding. We are certainly going to take the time to analyze this, and perhaps I will get back to you with some more detail. I believe we can get a revenue figure on this from the Congressional Budget Office.

Mr. DOYLE. It has been done, Mr. Chairman. They have analyzed it.

Mr. NOWAK. Is that the figure you gave me?

Mr. DOYLE. Yes. May I tell you where it has been, just so that it will be helpful to you?

Mr. NOWAK. Yes.

Mr. DOYLE. This thing has been approved by our southeastern board, and Senator Stennis picked up a copy of it; he liked it. He got in touch, and he got us through to the President's Economic Advisory Council; I presented it to Mr. Niskanen.

Mr. NOWAK. To whom?

Mr. DOYLE. Mr. William Niskanen. He is one of the three members of the President's Economic Advisory Council.

He said, "I find no problems with your mathematics. I find no problem with your claims." He simply said, "It is a transfer of funds. What are we going to take it away from to do this?"

I said, "Well, Mr. Niskanen, the Government doesn't have the money for these people unemployed. They are going to borrow it from somewhere. The private sector doesn't have it. They have got to get it from somewhere. Isn't it better that the private sector borrow it?"

Senator Stennis said, when we got outside, "You didn't really get a good answer to that one question." But other than that, we had a good discussion. The CBO has analyzed it. That is where my $1 billion figure came from.

Senator Stennis had his staff to draft a bill for it, a very simple bill, which I have, that we could share with you, if it is of some interest to you. Then my Virginia Chamber of Commerce board, which is the most conservative group that you would find anywhere as far as subsidies is concerned, have endorsed it.

Mr. NOWAK. Thank you very much. I would like to see that. If you have a copy to leave with us, I would appreciate that very much.

Thank you again for your testimony.

Now, we have Mr. Fred Schoenfeld, who is a member of the board of trustees of NSBA. He is the founder and owner of Select Brands Industries, Inc. He has come to us from Kansas City, Kans.

We appreciate your presence here.

Mr. SCHOENFELD. Thank you, Mr. Chairman.

My preeminence and reputation as a speaker has preceded me, and I think I have done a good job of emptying the chambers here. But in any case, I wasn't prepared to summarize, but I will do my very best to summarize my statement.

Mr. NOWAK. The press comes in, I have noticed, on various occasions, and they pick up the testimony.

Mr. SCHOENFELD. I told the Honorable Congressman from Louisiana that he left and, therefore, I was unable to use some of my best material, that he showed great patriotism in being here the day after Mardi Gras, but, nonetheless, he left.

What my testimony is concerned with are two things, interest rates, as it relates to capital formation, and also taxes as they relate to capital formation.

Over the past several years, interest rates have been the single greatest obstacle to capital formation as it relates to small- and medium-sized businesses. These high interest rates have been a tremendous drain on profits. Insofar as small business is concerned, virtually all capital formation must come from after tax profits or from additional investment. Whereas large corporations have the option of issuing additional stock or commercial paper, most small businesses must rely entirely on their own aftertax profit or private investment.

For the past several years, it has been extremely difficult for this important segment of the economy to formulate capital. This has had a far-reaching effect on the whole economy, considering that small business employs more than 60 percent of the nongovernment work force and has accounted for more than 80 percent of all new jobs of the past decade.

A recent article in the New York Times stated that the rate on bonds, which directly affects the prime rate, has historically been in the 2-percent to 3-percent range over the inflation rate, whereas now bonds are, roughly, settling for 6 percent above the inflation rate. The same is true of the spread between the cost of funds to banks and the prime rate.

Dr. Taub covered this adequately, and he has almost touched on the very same material, so I will skip over this.

The situation is exacerbated by the fact that even though most small business loans are secured and therefore are low risk loans, they are at prime or above, whereas many of the larger corporations receive unsecured loans at rates at 3 or 4 percent below prime. Not only does this different set of rules make it very difficult for small businesses to formulate capital, but it also makes it more costly and harder for the small businessman to compete in the marketplace, as his cost of funds is higher. As these small businesses are eliminated, competition lessens at the expense of the consumer and the Government itself.

It has been my contention for some time that interest rates have been hyped, not truly reflecting the current situation relative to

supply and demand. A banker recently admitted to me that his institution was receiving more money than they could place, thus having to wholesale their surplus. This explains the increasing spread between their CD rate and prime. The reports we are receiving at NSB verify that loan demand all over the country has been extremely soft and that most banks have a surplus of funds available for lending. Yet, in face of this, the money-center banks have the audacity to take two increases in prime during this past month, while the country is in the midst of what well could be the worse recession since World War II.

Yesterday we saw a slight backing off, but I thought it was audacious, at least, of them to take a raise in this kind of an economy, when generally all over the country we are hearing that loan demand is very, very soft.

I am going to skip some of my other testimony.

It has been emphasized and I have been writing for years to various people in the administration, and the President himself, that high interest rates make it that much more expensive to do business as a government and that possibly we are building inflation down the line for many, many, many years to come. One of the things that I am particularly concerned with is that no study has been made as to what the long-term effects of these high interest rates will be; for example, 5 years, 10 years, even 30 years down the line. Our policy is too much on a daily basis, and the Federal Reserve policy in particular. I don't think that anyone really knows what this long period of prolonged interest rates is going to do for the future.

I was privileged to testify before the House Subcommittee on Domestic Monetary Policy in November, and these were some of the things that we pointed up. That is, that there is a lot of untested theory out there that the Federal Reserve is using, and it seems to me that several weeks ago, when it was mentioned that there had been a rise of 1½ of a billion in the money supply figures, and the next week, I think, they said $1 billion in the money supply figures, suddenly the press became paranoid and they said interest rates must rise. This was despite the fact that there was very little loan demand out there. This is what I mean by the fact that I think the rates are being hyped.

When the Federal Reserve figures don't take into account the large amount of money being tied up in mergers and to fight off or ward off mergers, then we have an inexact science, determining the fate of hundreds of thousands of businessmen and millions of their employees. Something is going to have to be done to find a better and more accurate way of monitoring the money supply. I don't think the money supply figures as we have them today truly reflect the money and the credit in circulation. I think that until we find a better method, we are going to have this constant upward-downward swing every week, and somewhat paranoia in the money markets. Although there may be some justification for the long-term interest rates rising, I don't think there has been any justification for short term rates to be anywhere near where they are today.

The Federal Reserve has to answer to a better system. We don't have an exact science. I don't think anyone would agree that there

isn't tremendous fragility in their forecasting and in their control of the money supply. There surely can be a better formula and a better method, and I think some long-term studies should be made.

I realize that, for the sake of brevity, I am not going to delve into anything else except one other portion of my statement, and that is the inequity of our tax structure.

I have been writing to various people for a number of years, including Senator Dole, that it is unfair that we have a tax structure where successful small businesses and moderately successful small businesses are being taxed at near the 46-percent max tax rate. Most large businesses are taxed at a rate of somewhere around one-fourth that of the small business tax rate. Many of the largest corporations are paying very little or no taxes, even though these very same corporations receive the majority of Government services and the majority of Government contracts.

Some of the examples I had were major money center banks, which are being taxed at something like 2.8 percent on their worldwide income; some of the largest oil companies are being taxed at 9.4 percent; and some of the largest utilities at 5.1 percent, and on down the line. There are chemical companies—I think some of the largest—which are being taxed at the rate of nine-tenths of 1 percent.

If we are here to talk about capital formation, then we have to address the fact that all capital formation for small business comes from aftertax profit. Although this new bill pending before the House Ways and Means Committee and the Senate Finance Committee for a minimum floor tax of perhaps 15 percent is a good one, I think it should be used to bring down the deficit right now. I think if the deficit should ever become manageable, then we should bring the table of all business taxes down to a manageable level so that small business is playing in the same ballgame as big business and we don't have our hands tied behind us.

I think if you are interested in capital formation as it relates to small business, this is a very important issue that must be addressed.

Mr. Chairman, I thank you very much for your time. I think in my effort to be brief I probably have rambled somewhat, but I thank you for your indulgence.

[Mr. Schoenfeld's prepared statement follows:]

PREPARED STATEMENT OF FRED P. SCHOENFELD, ON BEHALF OF NATIONAL SMALL BUSINESS ASSOCIATION

NOTE.—"It is the declared policy of the Congress that the Government should aid, counsel, assist, and protect, insofar as is possible, the interests of small business concerns in order to preserve free competitive enterprise. . ."—(Public Law 85-536, as amended, Section 2(a), Small Business Act.)

Good morning Mr. Chairman and distinguished members of the Subcommittee. My name is Fred Schoenfeld. I am a member of the Board of Trustees of the National Small Business Association (NSB). With me today is Jerry Gulan, Vice President, Government Affairs.

The National Small Business Association is a private membership organization of about 50,000 enterprises in all lines of industry and in all parts of the country. We appreciate this opportunity to express our views on the impacts of current federal monetary policy on capital formation.

I am the founder and owner of Select Brands Industries, Inc., headquartered in Kansas City, Kans. We are involved in the wholesale distribution of housewares, appliances and consumer electronics, servicing the retail trade including department

stores, mass merchants, drug and grocery chains, catalog houses, as well as independent retailers. My company, founded in 1954, has enjoyed 27 consecutive, profitable years of increased sales and growth. Subsequently, we have been able to expand our operation to include four additional branches, located in Atlanta, Dallas, Houston and New Orleans. We now employ 300 people. For the first time ever, I find my company's future and those of my employees seriously threatened.

Over the past several years interest rates have been the single greatest obstacle to capital formation as it relates to small and medium sized businesses. These high interest rates have been a tremendous drain on profits. Insofar as small business is concerned, virtually all capital formation must come from after-tax profits, or from additional investment. Whereas large corporations have the option of issuing additional stock or commercial paper, most small businesses must rely entirely on their own after-tax profits or private investment.

For the past several years it has been extremely difficult for this very important segment of the economy to formulate capital. This has had a far-reaching effect on the whole economy, considering that small business employs more than 60 percent of the non-government workforce and has accounted for more than 80 percent of all new jobs of the past decade.

A recent article in the New York Times stated that the rate on bonds, which directly affects the prime rate, had historically been in the 2 percent to 3 percent range over the inflation rate, whereas now bonds are roughly selling for 6 percent above the inflation rate. The same is true of the spread between the cost of funds to banks and the prime rate. It seems unfair to me that, although most small business bankruptcies are at an all-time high, most banks, particularly the large, money-centered banks are garnering record profits. The situation is exacerbated by the fact that even though most small business loans are secured, (and therefore low risk), they are at prime or above, whereas many of the larger corporations receive unsecured loans at rates 3 percent or 4 percent below prime. Not only does this different set of rules make it very difficult for small businesses to formulate capital, but it also makes it more costly and harder for the small businessman to compete in the marketplace, as his cost of funds is higher. As these small businesses are eliminated, competition lessens at the expense of the consumer and the government itself.

It has been my contention for some time that interest rates have been "hyped", not truly reflecting the current situation relative to supply and demand. A banker recently admitted to me that his institution was receiving more money than they could place, thus having to wholesale their surplus. This explains the increasing spread between their C.D. rate and prime. The reports we are receiving at NSB verify that loan demand all over the country has been extremely soft and that most banks have a surplus of funds available for lending. Yet, in face of this, the money-centered banks have the audacity to take two increases in prime during this past month, while the country is in the midst of what could well be the worst recession since World War II.

I have been writing to this and past administrations of the danger of high interest rates to the government, as well as the private sector. I warned that these high rates are inflationary in themselves, wherein the cost of servicing government debt and quasi-governmental agencies, such as water districts and utilities, has risen as interest rates increased. I've stated that it would be harder to balance the budget as private and corporate income decline and debt-financing increases. Now suddenly, the Federal Government realizes that all of this has come to pass. Interest expense of Federal debt is rising at the very time that income tax receipts, both individual and business, are declining. Therefore, in all probability, the current estimate of the budget deficit could be grossly understated.

Although the deficit will require a large amount of Federal borrowing, and this will have an effect on long-term interest rates, I do feel that current, short term interest rates do not truly reflect the law of supply and demand. Rather, as I stated before, they have been "hyped" by the press. As long as rates remain high, not only can there be no capital formation in the small business sector, but there can be no sustained recovery in the general economy.

On October 29, 1981, I was privileged to testify before the House Subcommittee on Domestic Monetary Policy. I stated to this subcommittee that I felt there had been no study made to determine what the future, long-term effects will be, (5 years, 10 years, even 30 years from now), as a result of this prolonged period of stratospheric interest rates. The inflationary implications are staggering: manufacturing plants have not come on-stream, housing is not being built, the future debt-service on bonds and other debentures which are now being issued, will all be at a much higher rate. All of this will create tremendous inflationary pressure down the line.

In the meanwhile, hundreds of thousands of small businesses will be wiped out, as a result of high interest rates. This country will lose a large portion of its most creative and entrepreneurial talent and its most powerful job-generating resource. Are we to continue to lose this great resource, at the hand of the Federal Reserve and economists who are dealing with unproven and untested theory, which has been constantly revised as the fragility of their forecasting becomes apparent?

There has to be something wrong when a rise of half-billion or a billion-dollars in the money supply figures offers an immediate excuse to bump the prime rate up, when, in fact, there is no allowance in these very same figures for the sole purpose of acquisitions and mergers or to ward off acquisitions and mergers.

The Federal Reserve must develop a new formula which truly reflects the money and credit in circulation and one that does not penalize millions of small businesses and their millions of employees every time there is a merger of major proportions. It seems a bit ludicrous that a country as large and resourceful as the United States, does not demand a more exact and definitive methodology of monitoring the expansion and contraction of the money supply, than the present methods of the Federal Reserve.

Secondly, I would like to address the subject of taxes. As I explained before, most capital formation for small business is sourced by after-tax profits. For a number of years, I have written to members of the Congress, saying that the tax tables are inequitable, in that most successful and moderately successful small businesses are taxed at or near the 46 percent maximum tax rate. Many of this country's largest and most profitable concerns pay little or no tax at all.

In a recent study on the 1980 Corporate Federal Tax Burden,* which I have submitted for the record, I find the following figures to be poignant examples of such inequity:

1. The largest commercial banks in this country paid an average U.S. rate of 2.8 percent on worldwide income.
2. The largest oil companies paid an average U.S. rate of 9.4 percent on worldwide income.
3. One of the largest regulated utilities paid a U.S. rate of 5.1 percent on worldwide income.
4. The average U.S. tax rate on regulated utilities was 7.9 percent on worldwide income.
5. The largest chemical companies paid an average U.S rate of less than 1 percent on worldwide income.

This situation is even more unfair when considering that these corporations, that pay little or no taxes, are among the largest users of government services and the main recipients of government contracts.

I am not opposed to investment tax credits and I think they serve a useful purpose. However, I have always contended that every company should pay a minimum tax at around the 15 percent level. This minimum tax is now being considered by both the Senate Finance Committee and the House Ways and Means Committee as a means of generating additional revenue to help decrease the deficit. I think that this is a good idea for the present. However, if the deficit should become manageable, this minimum tax should be used to bring down the tax tables for all businesses, so that small businesses are playing in the same ballgame with the same rules, and don't have both hands tied behind their backs. Unless the tax tables come down, capital formation for small business will continue to be minimal, and the economy will not have the benefit of this essential, job-producing segment. There also will be inflationary implications if these businesses are not able to compete effectively in the marketplace.

I would like to call your attention to an article which appeared in the January, 1982 edition of INC. magazine. A copy of this article has been supplied for the record.

The information contained in this article was gleaned from two sources: (1) responses to a questionnaire which was sent to a sample of 2,000 small business subscribers; and (2) personal interviews with subscribers, asking their views on the economic outlook for 1982. Subscribers were asked to rank the major areas of concern, which they felt for their particular business. Interest rates, according to 53 percent of the respondents was the primary concern for small business in 1982. Moreover, interest rates was chosen 4 to 1 over the next item on the list, "Growth of the Economy". Two-thirds of the respondents consider tight monetary policy a threat to their company. I would like to quote several comments taken from personal interviews in

* "Tax Notes", Dec. 14, 1981.

the article, which are evidence of the desperate struggle for survival which most small businessmen feel today.

1. An accounting firm principal reports, "We have seen a lot of companies in the last couple of years that have produced no bottom line, especially in 1981. A lot of them have foregone expanding. They are trying to hold on to their cash flow and just reinvest it in doing the day-to-day operations of the business."

2. A manufacturing company president, "We are worried as much about what interest costs will do to our customers as what they will do to us. A year ago, we had our largest single bad-debt writeoff ever—somebody who had been a good customer for many years couldn't make it."

3. Subscriber: "The tight monetary policies of the Federal Reserve Board are encouraging inflation rather than stopping it. High interest rates mean high production costs, which are passed on to the consumers as higher prices."

4. William Barth, Partner and Director of Small Business Practice for the accounting firm of Arthur Andersen and Company, and a Trustee of the National Small Business Association, sums it all up: "About 2 years ago, small companies became aware of the need to help their working capital for their cash flow. They started with tightening receivables. Then about 6 months later, they went to inventories. About a year ago, they started on an austerity program in spending. Now, we've gone through all available means, and we have run out. Small business that we see, has run out of means to pare back and survive."

I have always felt that supply-side economics would be a viable remedy for many of our country's ills and certainly would go a long way to alleviate inflationary pressures. However, I think that to call present fiscal policy supply-side economics is a travesty and a misnomer. There can be no supply-side economics with high interest rates. I believe in order to have supply-side economics, you need to have both a reduction in taxes to allow capital formation, and a reduction in interest rates to spur investment in new production facilities, plants, production machinery and process. With these high interest rates, few prudent businessmen would borrow to invest in what they hope would be a satisfactory return in the future. Also with interest rates at these lofty levels, those with venture capital would find it more profitable and safer to "rat-hole" their money in high-paying and more liquid investments.

It would appear that our present policy has painted us into a corner, where we are in a "no-win" situation. Yet, no one has ever suggested that Federal Reserve control of the money supply has only worked for the benefit of the banks themselves. I am also fearful that this policy is resulting in a redistribution of the wealth at the expense of Federal revenue receipts, with most of the wealth ending up in the hands of those who are paying little or no taxes. This just increases the gap between revenue receipts and revenue expenditures.

On behalf of American small business, the National Small-Business Association and myself, I would like to thank you for the opportunity to express our views. Thank you very much.

Mr. NOWAK. Thank you very much, Mr. Schoenfeld, first of all, for taking time to come and testify before us. You have made a very important statement. It is a very good one, and you have covered the issue comprehensively in your written statement.

I had really been trying to concentrate on this issue of capital formation. I had the opportunity last year to testify before the Ways and Means Committee and urged them—and our committee urged them also—to go much further than they did in reducing the tax and moving from 50 to 100,000, and we wanted to go up to 250,000.

I think you are absolutely right. We have reached the stage in this country where, if we left the economic forces and the structure that seems to be in place now, I can only foresee much more drastic implications than even have been presented here today. I really don't know, if this structure is out there for another year or year and a half, how any small businessman—and I don't care how well-financed he is—is going to survive. He is going to start to see that if this interest rate structure stays up, he is going to be very tempted to start to reverse his investments and withdraw the money

from his small business and start to take advantage of those interest rates.

Mr. SCHOENFELD. Right.

Mr. NOWAK. You are going to condense the full community. You talked about borrowing for mergers; you are going to end up with 500 super-international companies without any competition, and it is very serious.

Mr. SCHOENFELD. They don't pay taxes either.

Mr. NOWAK. That's right. With the tax code, when you look at the little pieces, even like used equipment, the investment tax credit on used equipment, it doesn't make absolutely any sense to put that limitation on it.

Mr. SCHOENFELD. In my statement I did say almost exactly what you just said, that these large interest rates not only force the small businessman to have very little profit to reinvest for capital formation—or it may even force him out of business—but also it discourages investment in small business because people will take the safer way and rathole their money into short-term, high-paying interest investments, which do no good at all as far as reinvestment is concerned.

Mr. NOWAK. We are starting to limit very severely the opportunity of people to participate in this whole system. I mean the top is going to pyramid out, and you are not going to have anything reaching the innovation we are talking about and the personal interest and participation in this system is really going to be so drastically limited that you are going to find, unless you become a member of the system and you take the individual and put him in that corporate structure, he is not going to be able to grow.

Mr. SCHOENFELD. That's true. If I may just say one more thing, the INC magazine did a survey, asking "What is your No. 1 problem in 1982?" These questionnaires, went out to 2,000 small business people, and more than anything else, the No. 1 problem is interest rates, by a margin of more than 4 to 1.

I would like to say that although I am concerned about the unfairness of the tax structure, I am more concerned not only with our company's survival but the survival of hundreds and thousands of small businesses out there. Right now that is the one thing that more than anything else small businessmen are concerned about. They would be glad to pay taxes; they are concerned about staying alive, staying in business and surviving. So long as we have these prolonged periods of high interest rates, then they can't survive. Hundreds of thousands of them, if not millions of them, are being sentenced to death daily.

Mr. NOWAK. Did you have a comment, Mr. Doyle? I see that you are agreeing with something.

Mr. DOYLE. I was thinking, on the urgency of the thing, about what a lady in the office off the farm said before I left. She said, "Tell them there is such a thing as it's raining too late." You know, if you don't get something done, there are people who will be hurt. You can stay a while, but we have been down a minute now; when you say, "Stay down another minute," there are a lot of people that can't make it.

Mr. NOWAK. Well, I really did make a serious effort and really took the first step the Small Business Committee ever took in going

before the Ways and Means Committee instead of leaving that committee to run its own structured hearings. At least I think we made them aware of this problem. We are going to keep the momentum going, and we need organizations such as yours to come before us so we can translate that into one comprehensive package to bring to Ways and Means. You know, it is like anything else; it is a small number. I can't go in there and say, "We have a small business here, we have 50 people there." We are not going to have a tremendous impact if we don't act at all but if we can communicate to the committee the comprehensiveness of the small business interest out there, then perhaps in some real terms we can compete with the other testimony they are getting on the other side of this thing.

Somewhere there has got to be a break here. The chamber has presented a large portion of that big corporate view over there, and over the years we see the effect. Maybe it was just one thing. Let's take leasing. I am going to have a hearing on that tomorrow. You talk about large corporations; that is where they are getting the money to buy up everything else.

Mr. SCHOENFELD. Well, you know, there is a defect in that that may not be apparent to everybody, and that is even if a small business wanted to take advantage of the benefits of that leasing, what small business could afford the risks involved? In other words, in leasing, when you buy up a tax loss from somebody, you don't want to go out and buy a computer and lease it to somebody who is already losing money. Whereas a very large company like A.T. & T. can afford the risk of making the deal. So I would say there is virtually no value whatsoever to the small business community from that provision, and yet the small business community is responsible for 80 to 90 percent of all the new jobs that have come on stream in the last 10 years.

Mr. NOWAK. Yes. We have emphasized that over and over to the Ways and Means Committee, and tomorrow we hope to get that into some hard, concrete testimony. Again I will take that over to the Members over there and testify when they have their new round of hearings. I am trying to bring together as many groups as we can. I know it is difficult, and it is lonely in here. You don't have ABC covering it and CBS covering it with nighttime action because there are going to be Ways and Means votes. But at least in the last couple of years we have had some input over there, and without it I don't think we would even have got the slight changes we did, whether we are talking about inventory accounting or whether we are talking now about leasing and the slight changes we did get in the lowering of the interest rate.

Mr. SCHOENFELD. We did really have terrific support. Speaking for the National Small Business Association, we received terrific support from the Ways and Means Committee on the tax bill, and the tax bill as originally proposed by the Ways and Means Committee was pretty much in line with our thinking. The fact remains that, had that bill gone through, the deficit would have been a lot smaller than it is now, considerably smaller than it is today.

Mr. NOWAK. Sure.

Mr. SCHOENFELD. But also there is fragility in the deficit forecast, because the administration is assuming that the economy is going

to get well and that everybody is going to pay a lot of taxes. If you check around the country right now, for every business that is doing OK out there, there are 10 doing worse than last year, and last year wasn't particularly a great year either.

Mr. DOYLE. Mr. Chairman, may I say one thing?

Mr. NOWAK. Yes.

Mr. DOYLE. Did you happen to see the Irving Kristol article in the Wall Street Journal Friday a week ago as it relates to the Federal Reserve in the matter of calculating the situation of the money supply? He is with the American Enterprise Institute, and a very respected man. He said Volcker was not on trial, but the system was on trial in this sense: That, heretofore, when you had a savings account, you had some money over here, and you were drawing interest on it. It was pretty easy which caveat you would put that into; you had a checking account, you were getting no interest on it, and you knew where that was.

He said, "Now, I have some money in money markets, and I can write a check on it. Is that savings, or is that spendable?" I don't know. How do they know?

He went through a number of things where new things have come on line to complicate it. He simply narrowed it down to this fact: He said it is just prima facie evidence that if interest rates are too high and the spread between that and inflation is too great, there is something wrong with the system and money is too tight.

I think all we have said here today would boil down to one thing. In my industry, the lumber industry, the housing industry, furniture and appliances and all those things that relate to it, if we had a 13 percent money interest rate today, everything else that is in place, even that Congress had in place, in my opinion would be working reasonably well.

Mr. NOWAK. I think so. At least we would have a shot at trying to work it out in the economy; today we don't.

Mr. SCHOENFELD. I would hate to have to settle on that kind of a plateau. That is what I am afraid of. The danger now in the economy is that everybody is going to start thinking of 14 percent or 12 percent as a low rate, and the new plateau would be 15 or 16 percent. That would be very dangerous, I think, and very expensive for the Government, too, to finance its own debt.

Mr. NOWAK. Yes. But unfortunately, even that looks good to us right now. Again let me thank you for your participation. We are going to prepare summaries of this testimony. Unfortunately, the House has not had a session yet today, and the Members who were present had to leave. There were two markups in other committees, and they had to be physically present there for voice votes or to be recorded on rollcalls. But we will prepare summaries of your very important testimony and make sure that each Member, as well as their staffs, receives it and digests it so that we can keep them up to date as we go along. We want to bring some proposals to a logical conclusion from your testimony so we can go over there with some backup and show them that it is not just our own individual ideas.

Thank you very, very much for taking your time. I appreciate it, and I am sure the other members of the subcommittee appreciate it, too.

[Whereupon, at 12:50 p.m., the subcommittee adjourned, to reconvene subject to call of the Chair.]

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